



2012 KIEP VISITING FELLOWS PROGRAM

Edited by Chang Kyu Lee

The Korea Institute for International Economic Policy (KIEP) was founded in 1990 as a government-funded economic research institute. It is a leading institute concerning the international economy and its relationship with Korea. KIEP advises the government on all major international economic policy issues and serves as a warehouse of information on Korea's international economic policies. Further, KIEP carries out research by request from outside institutions and organizations on all areas of the Korean and international economies by request.

KIEP possesses highly knowledgeable economic research staff. Now numbering over 190, our staff includes 48 research fellows with PhDs in economics from international graduate programs, supported by more than 76 researchers. Our efforts are augmented by our affiliates, the Korea Economic Institute of America (KEI) in Washington, D.C. and the KIEP Beijing office, which provide crucial and timely information on local economies. KIEP has been designated by the government as its Center for International Development Cooperation and the National APEC Study Center. KIEP also maintains a wide network of prominent local and international economists and business people who contribute their expertise on individual projects.

KIEP continually strives to increase its coverage and grasp of world economic events, and expanding cooperative relations has been an important part of these efforts. In addition to many joint projects in progress KIEP is aiming to become a part of a broad but close network of the world's leading research institutes. Considering the rapidly changing economic landscape of Asia, which is leading to further integration of the world's economies, we are confident that KIEP's win-win proposal for greater cooperation and sharing of resources and facilities will increasingly become standard practice in the field of economic research.

2012 KIEP VISITING FELLOWS PROGRAM

Edited by Chang Kyu Lee

KOREA INSTITUTE FOR
INTERNATIONAL ECONOMIC POLICY (KIEP)
246 Yangjaedaero, Seocho-Gu, Seoul 137-747, Korea
Tel: (822) 3460-1042 Fax: (822) 3460-1043
URL: <http://www.kiep.go.kr>

Il HOUNG Lee, *President*

Published December 30, 2013 in Korea by KIEP

© 2013 KIEP

Contents

Acknowledgements	7
Notes on the Contributors	8
1. Services Trade Liberalization between Taiwan and China: Assessing the Impacts of the ECFA and Its Future Development — A One Year Review of Taiwanese Banks in China	11
<i>Kristy Tsun Tzu HSU (徐遵慈)</i>	
Introduction.....	11
Assessing the ECFA and Its Effects.....	13
Taiwanese Banks in China: First Year's Review.....	31
Conclusions.....	48
References.....	51
2. Accession to the WTO: The Case of Azerbaijan	54
<i>Aynura ISMAYILOVA</i>	
General Review.....	54
Historical Review of the Economics for the Last 20 Years: from 1991 to 2012.....	58
Azerbaijan is on the Way to WTO Membership: from 1997 until 2012.....	62
Azerbaijan's WTO Membership Wish: Expectations for Future.....	69
References.....	70
3. Features of the Currency Policy and Exchange Rate of Belarus in the Conditions of Forming the Common Economic Space	71
<i>Maryna Markusenka</i>	
Introduction.....	71
The Currency Exchange Rate Adjustment in the Republic of Belarus.....	73

Scientific Base of Methods and Instruments of Monetary Policy in the Common Economic Space (CES) Conditions.....	83
Conclusions.....	99
References.....	101
4. Services Sector in India and India-Korea Economic Cooperation.....	104
<i>Sandip Kumar Mishra</i>	
Introduction.....	104
Services Sectors of India.....	106
Issue of FDI in Services Sector.....	116
Issue of Employment.....	118
Challenges and Prospects in the Indian Services Sector.....	119
India-Korea Economic Cooperation.....	122
CEPA and Economic Cooperation.....	124
Indian Services Sector and Bilateral Cooperation.....	126
FDI from South Korea.....	129
Concluding Remarks.....	130
5. The Impact of the Internationalization of the Renminbi on Asian Economies	132
<i>Lee-Rong Wang</i>	
Introduction.....	132
Body.....	133
Conclusions.....	157
References.....	160
6. Comparative Research on Automotive Industry Policies between South Korea and China.....	162
<i>Fu Baozong</i>	
Introduction.....	162
Comparison of China and Korea's Development of Automobile Industry ..	163

Similarities in Automobile Industry Policies of China and Korea····	170
Differences of Automobile Industry Policies between China and Korea	177
Comparison on Results of Automobile Industry Policies between China and Korea····	183
Conclusions····	190
References····	192
7. Private Economy and Economy Transformation in China····	193
<i>Liu Xianwei</i>	
Introduction····	193
Development of Private Economy in China····	194
The Key for China's Economy Transformation····	206
Historical Mission of China's Private Economy····	223
Suggestion and Conclusion····	229
References····	232
8. Azerbaijan Economy: Diversification in lens of Modernization····	234
<i>Vusal Gasimli</i>	
Introduction····	234
Diversification Trends····	235
Causality Relationship between Economic Growth and Labor Productivity	249
Conclusion····	261
References····	262

9. Building a Korean-Portuguese Business Partnership for Sub-Saharan Africa: Opportunities and Challenges In Mozambique..... 266

Luis Mah

Introduction.....	266
From “Hopeless” to “Hopeful” Continent: The Rise of Sub-Saharan Africa.....	267
Go Africa? Korea’s Engagement with the Emerging Continent.....	273
The Political Economy of Mozambican Growth and Development.....	275
Portugal as a Business Partner for Korea in Mozambique.....	288
Conclusion.....	295
References.....	297

10. The Second-Tier “Tigers” in the Light of Latin American Experience..... 306

Victor Krasilshchikov

Introduction: “Unhappy” Latin America and “Lucky” East Asia.....	306
Comparing Latin America to East Asia: Visible Differences and Hidden Similarities.....	309
“A Santa Fé” Tecnocrática: The Brazilian Experience and Its Implications	316
The Second-tier “Tigers” from the Rise to Distress (1970s – 1997)...	321
The Post-Crisis Development (1998 and onwards): Did the “Tigers” Make Right Conclusions?.....	329
Towards a Knowledge-Based Society?.....	342
Conclusion.....	347
References.....	349

Acknowledgements

Korea Institute for International Policy (KIEP) has expanded its cooperative relations with the world since it took the role of the hub of regional studies in public research areas of Korea. The Center for Emerging Economies Research (CEER), the largest part of KIEP stands at the forefront of Korea's emerging economic research field, and has played a pivotal role of regional studies of the world in Korea.

As a part of our systematic efforts to foster international exchanges and build the knowledge based through interdisciplinary collaboration, CEER initiated a researcher-exchange program called the Visiting Fellows Program in 2008. The program brings together influential professionals from academia and the public sector to advance individual, institutional and national understanding of regional economic matters and to improve international cooperation on related research.

This volume is a part of our achievements through the program. It is comprised of ten papers contributed by visiting scholars participated in the Visiting Fellows Program in 2012. I hope this proceeding would work as another channel to deepen the understanding of emerging economies in Korea.

I would like to express my special thanks to all participated scholars who contributed in the book. I would also deeply appreciate the President of KIEP, Dr. Lee, Il Hounq for his endless supports for the program and emerging economies research, and my colleagues, Juneyoung Choi, Mijung Woo, and Seung Jin Lee from the Outreach and Research Cooperation team in CEER who worked very hard for the publication of this volume.

Chang Kyu Lee

Director

Center for Emerging Economies Research

Notes on the Contributors

Dr. Kristy Tsun-Tzu HSU was a visiting fellow at KIEP March 2012, and is an associate research fellow at Chung Institution for Economic Research, J.D. Soochow University, Taiwan

Dr. Aynura M. Ismayilova is the Head of the Department of Coordination and Training at the Institute for Scientific Research on Economic Reforms for the Ministry of Economic Development of the Republic of Azerbaijan. She has worked for the Institute since from 2009.

Her fields of research and teaching areas of interest are data analysis, research methodology, information technology management, and business-training. Her recent research includes preparation of PhD thesis, and studying public opinion, and SPSS analysis.

She received her B.A. degree in Mathematics and Information Technologies from Baku State University (Azerbaijan), her M.Sc. degree in Mathematical Modeling from Baku State University (Azerbaijan), and she graduated Master in International Public Affairs from School of Government, LUISS “Guido Carli” University (Italy).

Dr. Maryna Markusenka received Ph.D. in Economics and is an associate professor at the Institute of Economy of the National Academy of Science of Belarus (Republic of Belarus, Minsk).

Dr. Sandip Kumar Mishra is an assistant professor of Korean Studies at University of Delhi, India. He is also concurrently a Visiting Fellow at the Institute for Peace and Conflict Studies, New Delhi and Adjunct Fellow at the Institute of Chinese Studies, Delhi. He received his Ph.D from Jawaharlal Nehru University, New Delhi in Korean Studies. His areas of interest are Korean Political Economy, International Relations of East Asia and Korea,

North Korean Nuclear Issue, East Asian Security, and India-Korea Relations.

Dr. Lee-Rong Wang was a visiting fellow at KIEP (August 24 to September 8, 2012) and a research fellow at the Chung-Hua Institution for Economic Research (CIER), Taiwan, R.O.C. Lee-Rong Wang has majored in international finance and macroeconomics.

Dr. Fu Baozong works as a research associate in the Academy of Macroeconomic Research, National Development & Reform Commission of the PRC. Being a results-driven researcher with strong background in macro-economics, he focuses his studies on industrial competence, industrial structure and industrial policy. In recent years, he has organized and participated in more than 30 academic research projects, published about 50 papers, and received more than 10 academic awards for outstanding research achievements.

Dr. Liu Xianwei, Ph.D. and Master degree from Renmin University of China, Major in Business Management; Bachelor degree from Beijing Jiaotong (transportation) University, Major in Mechanical Engineering. Assistant researcher at the Institute of Economic System and Management(IESM), Academy of Macroeconomic Research(AMR), National Development and Reform Commission(NDRC), P.R. China. Published more than 20 papers on economics and management in Chinese or English language, 6 translation books from English into Chinese, 1 personal book and some joint publications; host or participate more than 20 research programs, and authored more than 20 related working papers and research reports.

Dr. Vusal Gasimli works as the Head of Department in the Center for Strategic Studies under the President of the Republic of Azerbaijan. A researcher with strong background in macroeconomics; focus on research on such areas including competitiveness, modernization and agriculture. In recent years, he has hosted and participated in more than 20 academic research projects, published about 500 articles, wrote or co-authored 10 books, received award from the Astana Economic Forum for outstanding research achievements in 2012. Dr. Vusal Gasimli provided lectures in prestigious universities such as Washington, Warsaw, Milan Catholic, Hanyan and Hankook.

Dr. Luís Mah Silva is currently a Research Fellow at the Center for African and Development Studies (CESA) at the School of Economics and Management (ISEG) /Technical University of Lisbon, Portugal. He holds a PhD in Development Studies from the London School of Economics and Political Science (2004). From 2007 to the end of 2010, Luis Mah was the director of the United Nations Millennium Campaign in Portugal. He has also worked in the NGO sector and as a journalist.

Dr. Victor Krasilshchikov works at the Institute of World Economy and International Relations (Russian Academy of Sciences), Moscow, where he is head of research group of the Centre for Development and Modernisation Studies. In addition, he is convener of the working group “Transformations in the World System – Comparative Studies of Development” of EADI (European Association of Development Research and Training Institutes), Bonn. Graduated from the Economic faculty of Moscow State University, obtained the scientific degrees of Ph.D. (1982) and Doctor of Sciences (economics) (2002). In February 2013, Prof. Victor Krasilshchikov worked as visiting fellow of KIEP. The given paper has been his contribution to the KIEP research program.

Services Trade Liberalization between Taiwan and China: Assessing the Impacts of the ECFA and Its Future Development — A One Year Review of Taiwanese Banks in China

Kristy Tsun Tzu HSU (徐遵慈)¹⁾

I. Introduction

In October 2008, President of Republic of China (Taiwan), Dr. Ma Ying-Jeou,²⁾ announced a decision to negotiate a framework trade agreement with the People's Republic of China (PRC) in the Mainland.³⁾ On June 29, 2010, an Economic

1) Kristy Tsun Tzu Hsuisan, Associate Research Fellow at Chung Institution for Economic Research; J.D. Soochow University, Taiwan.

2) On May 20th, 2008, President Ma Ying-jeou was inaugurated President of the Taiwan (ROC), who represented KMT in the election and won the presidency by 58.45% of the popular vote over Frank Hsieh, the candidate of the then-ruling DPP. The KMT regained power after former president Chen Shui-bian of DPP won the 2000 and 2004 presidential elections. See KMT Official website at <http://www.kmt.org.tw/english/index.aspx>.

3) Earlier in June 2008, in the long postponed “Chiang-Chen Talks”, Taiwan and China agreed on the principle of addressing the economic issues first while putting aside political issues,

Cooperation Framework Agreement (ECFA) was signed by the Taiwan-based Straits Exchange Foundation (SEF) and the Beijing-based Association for Relations Across the Taiwan Strait (ARATS) at the Fifth Chiang-Chen Talk in Chongqing, China.⁴⁾ The Framework Agreement, together with the launch of the “three links”⁵⁾ earlier in 2008 and the signing of 14 other Cross-Straits Cooperation Agreements,⁶⁾ moved the cross-Straits relations towards a new era.

A year has passed since the entry into force of the ECFA. An examination into how Taiwan’s economy and industries are affected will help evaluate the ECFA and shed light on future policy formulation for Taiwan. This paper aims to analyze the ECFA and, by making a preliminary case study of the banking sector, to review its impacts on cross-Straits services liberalization and on entry of Taiwanese banks into the Chinese market.

Firstly, the paper introduces recent cross-Straits interaction and the negotiations of the ECFA and its subsequent agreements. Secondly, the paper examines the ECFA commitments and investigates if the preferential treatments of the ECFA increase Taiwanese banks’ competitive advantage and create better conditions in China. To address this issue, the paper also compares the ECFA and the CEPA signed between China and Hong Kong, in order to find out how “preferential” the ECFA is in helping Taiwanese investors and services providers. As an empirical part in the paper, the banking sector is selected as a preliminary

known as the “easy issues first, controversial issues later” approach.

- 4) Chiang-Chen Talks refer to Mr. Chiang Pin-kung, Chairman of SEF, and Mr. Chen Yunlin, Chiang’s counterpart at ARATS. Chiang and Chen represented governments of Taiwan and China for talks on selected issues, while avoiding giving the impression of direct government-to-government negotiations across the Strait.
- 5) The “Three Links” took effect on December 15th, 2008, meaning direct postal service, sea and air transports across the Taiwan Strait.
- 6) 14 agreements were signed by the SEF and ARATS during the Chiang-Chen Talks, covering topics ranging from postal service, sea transport, air transport, food safety to joint crime-fighting, judicial mutual assistance, and etc. In the 6th and 7th Chiang-Chen Talks, after the signing of the ECFA, 3 more agreements were signed. Available at the Mainland Affairs Council website, at <http://www.mac.gov.tw/sitemap.asp?mp=3>.

case study of liberalization commitments of the Early Harvest Program of the ECFA; to review the Taiwanese banks' operation in the Mainland, their latest development since the ECFA became effective, and opportunities and challenges in further exploring the Chinese market. Finally, the paper concludes.

II. Assessing the ECFA and Its Effects

(1) Taiwan's Cross-Straits Policy

Taiwan's earliest trade activities with China can be dated back to the 1980s. In 1987, the government decided to relax the policy that had prohibited its citizens from visiting and making direct contacts with mainland China for decades.⁷⁾ In August 1988, imports of Chinese products were allowed for the first time under an item-by-item, positive-list approached scrutiny mechanism. This revolutionary policy change marked a milestone in cross-Straits relations and opened the door for Taiwanese investors craving for cheaper labour and untapped market potential in the Mainland. Since the late 1990s, China has become the most important destination for Taiwan's outward Foreign Direct Investments (FDIs). The investment plans started with small- and medium- sized companies in labour intensive industry and gradually expanded to larger companies and more technology and capital intensive industry. It is estimated that in the past 20 years Taiwan has invested more than US\$ 100 billion in China, including investment by 1,052 public listed companies⁸⁾ and numerous Small- and Medium-Sized companies (SMEs) in Taiwan. More than 80 percent of the FDI were made between 2000 and 2010.⁹⁾

7) After President Chiang Ching-kuo decided to lift the martial law on July 5th, 1987, he further announced relaxation of the prohibition, and, starting November 2nd, 1987, Taiwan citizens were allowed to visit their relatives and family members in Mainland China.

8) Index of Listed Taiwanese Companies investing in the Mainland (1991-2010), MOEA, Taiwan, available at <http://www.moeaic.gov.tw/>

On April 27th ~ 29th, 1993, the historic Koo-Wang Talks¹⁰⁾ took place in Singapore after years of preparation and endless consultation between the two governments' designated intermediary agencies - the Strait Exchange Foundation (SEF) in Taipei and the Association of Relations Across the Taiwan Strait (ARATS) in Beijing. The Talk was concluded with four agreements signed between Dr. Koo Chen-fu (辜振甫), the SEF Chairman, and Mr. Wang Daohan (汪道涵), the ARATS Chairman, which include the Agreement on the Use and Verification of Certificates of Authentication Across the Taiwan Straits, the Agreement on Matters Concerning Inquiry and Compensation for [Lost] Registered Mail Across the Taiwan Straits, the Agreement on the System for Contacts and Meetings between SEF and ARATS, and the Joint Agreement of the Koo-Wang Talks.

The 2nd Koo-Wang Talk took place in Shanghai in October 1998. However, the talks discontinued since then as a result of then President Dr. Lee Tung-hui's "state-to-state" statement¹¹⁾ and the Democratic Progress Party (DPP) winning the Presidential election in 2000 and thus staying in power to 2008.¹²⁾ It was not until June of 2008 after President Ma took office then the SEF and ARATS resumed their "institutional dialogues" after 15 years of non-contact. Over the years since President Ma took office and initiated a series of measures to enhance cross-Straits

9) According to Department of Investment Services, Ministry of Economic Affairs, Taiwan, as of April 2011, accumulated investment in China totaled US\$102.12 billion, available at <http://www.dois.moea.gov.tw/content/doc/10004-3.xls>.

10) Koo-Wang Talks refer to talks between Dr. Koo Chen-fu and Mr. Wang Daohan, chairman of the SEF and the ARATS respectively. It was the first cross-Straits talk since 1949. The Koo-Wang Talks was replaced by the Chiang-Chen Talks in the 2000s after Dr. Koo passed away in 2005.

11) President Dr. Lee Teng-hui (李登輝) openly stated that the cross-Straits relations should be conducted as a "state-to-state" or at least as "special state-to-state" relations. Chinese government then decided to postpone the 3rd Koo-Wang Talks.

12) The DPP candidate Chen Shui-bian (陳水扁) won the presidency in March 2000, becoming the first-ever non-KMT president in the history of the ROC. President Chen has called for resuming the cross-Straits dialogue without any preconditions. Though President Chen has called for cross-Straits talks to be continued, the Chinese government, however, insisted that Chen must recognize the "one China principle" before any agreement to resume talks.

Table 1. Cross-Straits Agreements signed between SEF and ARATS since 1990

Titles	Date of Signature
Kinmen Accord	Sep 12, 1990
Agreement on the System for Contacts and Meetings Between SEF and ARATS	May 24, 1993
Agreement on Matters Concerning Inquiry and Compensation for (Lost) Registered Mail Across the Taiwan Straits	May 24, 1993
Agreement on Use and Verification of Certificates of Authentication Across the Taiwan Straits	May 24, 1993
Agreement Concerning Cross-Straits Charter Flights	June 13, 2008
Agreement Concerning Mainland Tourists Travelling to Taiwan	June 13, 2008
Cross-Straits Postal Service Cooperation Agreement	Nov. 4, 2008
Cross-Straits Sea Transport Agreement	Nov. 4, 2008
Cross-Straits Air Transport Agreement	Nov. 4, 2008
Cross-Straits Food Safety Agreement	Nov. 4, 2008
Consensus Reached Between the SEF and ARATS Concerning Mainland Investment in Taiwan	May 22, 2009
Cross-Straits Financial Cooperation Agreement	May 22, 2009
Cross-Straits Air Transport Supplementary Agreement	May 22, 2009
Cross-Straits Joint Crime-Fighting and Judicial Mutual Assistance Agreement	May 22, 2009
Cross-Straits Agreement on Cooperation of Agricultural Product Quarantine and Inspection	Dec. 22, 2009
Cross-Straits Agreement on Cooperation with Respect to Standards, Metrology, Inspection and Accreditation	Dec. 22, 2009
Cross-Straits Agreement on Cooperation with Respect to Fishing Crew Affairs	Dec. 22, 2009
Cross-Straits Agreement on Economic Cooperation Framework Cooperation	June 29, 2010
Cross-Straits Agreement on Intellectual Property Right Protection and Cooperation	June 29, 2010
Cross-Straits Agreement on Medical and Health Cooperation	Dec. 19, 2010
Cross-Straits Nuclear Power Safety Cooperation Agreement	Oct. 12, 2011

Sources: Council for Mainland China Affairs, at
<http://www.mac.gov.tw/ct.asp?xItem=60739&CtNode=6535&mp=202>

relations, atmosphere across the Strait has been improved and hence allowed both governments to gradually move from confrontation to negotiation and from conflict to conciliation.

As of February of 2012, the two sides have arranged to conduct 7 rounds of Chiang-Chen Talks and have successfully signed 17 legal instruments in the name of Cross-Straits Cooperation Agreement. These Agreements' areas of coverage include joint crime fighting and mutual assistance in judicial matters; postal services, sea and air transport, food safety, financial cooperation, intellectual property rights protection, and nuclear power safety cooperation, and etc. (See Table 1)

Among these agreements, the Agreements on Air Transport and Agreement Concerning Mainland Tourists Travelling to Taiwan have created significant implications beyond their economic impacts. It was only in 2009 that direct flights between Taiwan and various Chinese cities were made possible. Moreover, Chinese tourists from the Mainland for the first time in the past 60 years were allowed to visit Taiwan. According to statistics released by the Tourism Bureau of the Ministry of Transportation and Communications (MOTC) in Taiwan, in 2008 there were around 329,204 inbound Chinese tourists and the number soon increased to around 1.8 million in 2011. By the end of 2009, Chinese tourists have outnumbered Japanese tourists and become the largest source of inbound tourists in Taiwan.¹³⁾

(2) The Cross-Straits Economic Cooperation Framework Agreement (ECFA)

The signing of the ECFA in 2010 represents a landmark in Cross-Straits relations and is often regarded as the most important accomplishment, by far, of President Ma's Cross-Straits policy.¹⁴⁾ In order to gain support from the opposition

13) See Yearly Statistics, Tourism Bureau, M.O.T.C, Taiwan, available at <http://admin.taiwan.net.tw/statistics/year-en.aspx?no=15>

14) For example, the BBC appraised the ECFA as the most significant agreement across Taiwan Strait in the past 60 years. BBC, June 29, 2010.

party and the general public, President Ma announced a “Three No and Three Must” policy for the negotiation, meaning “No to downgrading Taiwan’s sovereignty, No to opening Taiwan to labour from Mainland, and No to further opening Taiwan to imports of Mainland agricultural products,” and in the meantime “Must forge consensus, Must proceed gradually in proper sequence, and Must build good feelings.”

The ECFA was signed on June 29, 2010, in Chengdu, China, and ratified by respective legislatures in August 2010. It entered into force on September 12th, 2010, while liberalization of the services and tariff reduction of the goods under the agreement’s Early Harvest Program (EHP)¹⁵⁾ took effect in October 2010 and January 2011 respectively.

The ECFA is comprised of 5 chapters, 16 articles¹⁶⁾ and 5 annexes.¹⁷⁾ As stipulated in the objectives, the two Parties agree to take measures to strengthen and advance the economic, trade and investment cooperation; to promote further liberalization of trade in goods and services and gradually establish fair, transparent and facilitative investment protection mechanisms; to expand areas of economic cooperation and establish a cooperation mechanism.¹⁸⁾ The goal is to move towards the realization of a cross-Straits free trade area in order to strengthen mutual economic benefits and international competitiveness.

15) An early harvest program or mechanism is usually used in the initial stage in order to persuade further development into an FTA. For example, Thailand and China agreed to tariff reductions on fruits and vegetables as an early harvest to initiate their FTA negotiation.

16) The English/Chinese text of the agreement is available at <http://www.ecfa.org.tw>.

17) They are Annex I: Product List and Tariff Reduction Arrangements Under the Early Harvest for Trade in Goods; Annex II: Provisional Rules of Origin Applicable to Products Under the Early Harvest for Trade in Goods; Annex III: Safeguard Measures Between the Two Parties Applicable to Products Under the Early Harvest for Trade in Goods; Annex IV: Sectors and Liberalization Measures Under the Early Harvest for Trade in Services; and Annex V: Definitions of Service Suppliers Applicable to Sectors and Liberalization Measures Under the Early Harvest for Trade in Services.

18) Article 1 of the ECFA.

Article 3¹⁹⁾ and 4²⁰⁾ stipulate that the ECFA, being a Framework agreement; the two Parties, on the basis of the Early Harvest Program, will conduct consultations on an agreement on trade in goods and an agreement on trade in services no later than 6 months after its entry into force, and will expeditiously

19) Article 3: Trade in Goods:

1. The two Parties have agreed, on the basis of the Early Harvest for Trade in Goods as stipulated in Article 7 of this Agreement, to conduct consultations on an agreement on trade in goods no later than six months after the entry into force of this Agreement, and expeditiously conclude such consultations.
2. The consultations on the agreement on trade in goods shall include, but not be limited to:
 - (1) modalities for tariff reduction or elimination;
 - (2) rules of origin;
 - (3) customs procedures;
 - (4) non-tariff measures, including but not limited to technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures;
 - (5) trade remedy measures, including measures set forth in the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994, the Agreement on Subsidies and Countervailing Measures and the Agreement on Safeguards of the World Trade Organization, and the safeguard measures between the two Parties applicable to the trade in goods between the two Parties.
3. Goods included in the agreement on trade in goods pursuant to this Article shall be divided into three categories: goods subject to immediate tariff elimination, goods subject to phased tariff reduction, and exceptions or others.
4. Either Party may accelerate the implementation of tariff reduction at its discretion on the basis of the commitments to tariff concessions in the agreement on trade in goods.

20) Article 4 Trade in Services:

1. The two Parties have agreed, on the basis of the Early Harvest for Trade in Services as stipulated in Article 8, to conduct consultations on an agreement on trade in services no later than six months after the entry into force of this Agreement, and expeditiously conclude such consultations.
2. The consultations on the agreement on trade in services shall seek to:
 - (1) gradually reduce or eliminate restrictions on a large number of sectors in trade in services between the two Parties;
 - (2) further increase the breadth and depth of trade in services;
 - (3) enhance cooperation in trade in services between the two Parties.
3. Either Party may accelerate the liberalization or elimination of restrictive measures at its discretion on the basis of the commitments to liberalization in the agreement on trade in services.

conclude the 2 agreements.

Article 5 stipulates that the two Parties will conduct consultations on investment and related matters within 6 months with an aim to conclude a cross-Straits investment agreement. The agreement shall include, but not be limited to, establishing an investment protection mechanism, increasing transparency on investment-related regulations, gradually reducing restrictions on mutual investments and promoting investment facilitation. The ECFA provides a legal basis for opening Chinese investment in Taiwan and is highly regarded by the Chinese government in encouraging Chinese enterprises to set foot in Taiwan.

According to Article 11 of the institutional arrangement,²¹⁾ Taiwan and China established a Cross-Straits Economic Cooperation Committee in March 2011 and launched further negotiations. In the 6th and 7th Chiang-Chen Talks, intensive consultations were made on the investment agreement. According to SEF, the agreement will likely be concluded in 2012, making it the second agreement following the ECFA in its subsequent negotiations.²²⁾

21) Article 11 Institutional Arrangements

1. The two Parties shall establish a Cross-Straits Economic Cooperation Committee (hereinafter referred to as the Committee), which consists of representatives designated by the two Parties. The Committee shall be responsible for handling matters relating to this Agreement, including but not limited to:
 - (1) concluding consultations necessary for the attainment of the objectives of this Agreement;
 - (2) monitoring and evaluating the implementation of this Agreement;
 - (3) interpreting the provisions of this Agreement;
 - (4) notifying important economic and trade information;
 - (5) settling any dispute over the interpretation, implementation and application of this Agreement in accordance with Article 10 of this Agreement.
2. The Committee may set up working group(s) as needed to handle matters in specific areas pertaining to this Agreement, under the supervision of the Committee.
3. The Committee will convene a regular meeting on a semi-annual basis and may call ad hoc meeting(s) when necessary with consent of the two Parties.
4. Matters related to this Agreement shall be communicated through contact persons designated by the competent authorities of the two Parties.

22) Central News Agency, February 15, 2012.

Under the Early Harvest Program, tariff reduction for a total of 806 products divided into 3-year phases took effect on January 1st, 2011.²³⁾ Early liberalization of 9 services sectors and sub-sectors of Taiwan and 11 services sectors and sub-sectors of the Mainland also took effect. The inclusion of the early liberalization of services sectors has marked the ECFA as the very few, if not the only, of its kind to go beyond trade in goods under the Early Harvest Program.²⁴⁾ The early services liberalization reflects the nature of the already deep cross-Straits economic integration and that both Taiwan and the Mainland wish to move from cooperation of manufacturing industries to services industries.

Commitments of Taiwan on liberalization of service sectors and sub-sectors in the Early Harvest Program include: research and development services (CPC 851, 852, 853), convention services(part of CPC 87909), exhibition services (CPC87909), specialty design services (CPC87907), motion pictures projection services(Chinese-language motion pictures), commission agents' services(except live animals)(CPC 621), sporting and other recreational services (CPC 96411, 96412, 96419), computer reservation system of air transport services, and last but not least, banking and other financial services (excluding securities, futures and insurance). While commitments of the Mainland on liberalization of service sectors and sub-sectors include: accounting, auditing and book-keeping services(CPC862), software implementation services(CPC842), data processing services(CPC843, excluding CPC8439), research and experimental development services on natural sciences and engineering (CPC8510), convention services (CPC87909), specialty design

23) China has agreed to eliminate or reduce tariffs of a total of 539 products from Taiwan in the next two to three years, while Taiwan has agreed to eliminate or reduce tariffs of 267 products imported from China, including 18 agricultural products, available at <http://www.ecfa.org.tw/EcfaAttachment/ECFADoc/ECFA.pdf>

24) There are a number of framework agreements that include Early Harvest Programs. Some examples in the Asia-Pacific region include the Framework Agreement on Comprehensive Economic Cooperation between ASEAN and China (2002) and the Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India (2003). A majority of, if not all, of the EHP of these agreements include early liberalization of trade in goods only.

services (CPC87907), audiovisual services -videos, including entertainment software and (CPC83202), distribution services -sound recording distribution services, hospital services (CPC9311), aircraft repair and maintenance services (CPC8868), and insurance and insurance - related services, banking and other financial services (excluding securities, futures and insurance), securities, futures and other related services.

According to Article 8 regarding the Early Harvest for Trade in Services, Taiwan and China shall reduce or eliminate the restrictive measures in force affecting the services and service suppliers of the other Party. However, it also stipulates that, in the event that the implementation of the Early Harvest Program for trade in services causes a adverse material impact on the services sectors of one Party, the affected Party may request consultation with the other Party to seek a solution. This article, reflecting Taiwan's deep concerns over China's large scale and capital rich services enterprises, leaves room for possible safeguard measures if Taiwan is impacted after opening up its market.

It should be noted that, when analyzing the specific services commitments in Annex IV of the agreement, one may find that both sides focus on commitments mainly in Mode 3, the Commercial Presence, and made hardly any further concessions in Mode1, 2 and 4, in addition to their commitments to the WTO members.²⁵⁾ On Taiwan side, this resulted from President Ma's promise of the "Three No" policy including not allowing natural persons from China to work in Taiwan, even temporarily. As for China, it can be explained by China's position which is not to make further commitments, except in Mode 3, in negotiating FTAs with other countries. Details of China's stance will be discussed later in the paper.

25) Pursuant to Article I:2 of the General Agreement of the Trade in Services (GATS) of the WTO, there are 4 modes of services supply: Mode 1: Crossborder trade, from the territory of one Member into the territory of any other Member; Mode 2: Consumption abroad, in the territory of one Member to the service consumer of any other Member; Mode 3: Commercial presence, by a service supplier of one Member, through commercial presence, in the territory of any other Member; and Mode 4: Presence or Movement of natural persons, by a service supplier of one Member, through the presence of natural persons of a Member in the territory of any other Member.

In the commitments of the financial services, including banking and other financial services but excluding securities, futures and insurance; Taiwan has agreed that Chinese banks which have been permitted to establish representative offices in Taiwan and whose offices have been so incorporated for one full year, may apply for incorporation of branches. While China has agreed that, for Taiwanese banks to set up wholly owned banks or branches (not branches affiliated to a wholly owned bank) in the Mainland, they shall have representative offices in the Mainland for more than one year before application; and, for the operating branches of Taiwanese banks in the Mainland to apply to conduct RMB business, they shall have been operating in the Mainland for more than two years and be profitable in the preceding year before application. As for the operating branches of Taiwanese banks to apply to conduct RMB business for Taiwanese enterprises in the Mainland, they shall have been operating for more than one year and profitable in the preceding year. Chinese authorities shall take into account the overall performance of the Taiwanese banks under assessment in conducting profitability assessment on their branches.

China has also agreed for the operating branches of Taiwanese banks to set up special agencies providing financial services to small businesses. The specific requirements shall follow relevant rules announced in the Mainland. Moreover, “fast tracks” shall be established for Taiwanese banks applying to set up branches in central, western, and northeastern regions of the Mainland.

In addition to banking, China also has agreed for the insurance and related services, groups formed by Taiwanese insurance companies through integration or strategic mergers shall be allowed to apply for entry into the Mainland insurance market with reference to market access conditions for foreign-funded insurance companies.

China has agreed to lower the capital requirements of the foreign insurance companies for the sake of Taiwan. Therefore, for Taiwan’s application, total assets held by the group of over US\$ 5 billion; one of the Taiwan insurance companies in the group should have more than 30 years of operations following establishment

experience; and a representative office established and maintained in the Mainland for over 2 years by any one of the Taiwan insurance companies in the group are considered as meeting the requirement.

As for securities, futures and other related services, proper facility shall be provided to the qualified Taiwan-funded financial institutions applying for qualification of Qualified Foreign Institutional Investor (QFII) in the Mainland. Taiwan Stock Exchanges and Taiwan Futures Exchanges shall be included as soon as possible in the List of Overseas Exchanges Recognized by the Mainland for QDII to invest in financial derivatives. Relevant procedures shall be simplified for Taiwanese securities practitioners applying for and obtaining qualifications and certificates of practice in the Mainland.

According to Chinese accession commitments to WTO members, foreign banks shall have representative offices in the Mainland for more than 3 year and shall have been profitable in the preceding 2 years before application for transformation of the offices into branches. The Early Harvest Program of the ECFA provides preferential treatment to Taiwanese banks by allowing shorter operating years and profitability period, especially important to Taiwanese banks, being latecomers in the Mainland. For insurance services, foreign insurance companies shall meet the requirement of over US\$5 billion of their total assets in the preceding year before application, while in the ECFA, the US\$5 billion will be applied to the whole Taiwanese group, instead of the individual company. This is also a significant preferential treatment to the generally smaller scale Taiwanese insurance companies compared to their multinational gigantic competitors. In addition, the “fast track” and more flexibility of Taiwanese banks to provide banking services to small companies will also help Taiwanese banks to deal more efficiently with their potential clients and develop new business opportunities.

To prepare for financial liberalization, before the signing of the ECFA, the two sides signed the Cross-Straits Financial Cooperation Agreement in the 3rd Round of the Chiang-Chen Talks in April 2009. The Financial Supervision

Commission (FSC) of Taiwan and CFRC of China have agreed to enter into further negotiation in order to establish mechanisms for cooperation in supervision of cross-Straits banking, securities, and futures and insurance industries respectively. Following the Cooperation Agreement, the banking, securities and insurance supervisory agencies of two sides then signed the memorandums of understanding on banking, securities and future, and insurance supervision respectively.²⁶⁾

The signing of the 3 MOUs lay the foundation for Taiwan's financial institutions to set up branch offices in the Mainland. According to the Regulations of the People's Republic of China on Administration of Foreign-funded Banks effective since 2006, all foreign countries shall establish an MOU of financial supervision cooperation between their financial supervision authorities and their Chinese counterparts before their financial institutions can apply for business operation in the Mainland. The three cross-Straits MOUs of financial supervision cooperation hence, on the one hand, are "admission tickets" for Taiwanese financial institutions to set foot in China's financial market, followed by further negotiations in the ECFA. On the other hand, the MOUs provide a platform of regular dialogues and information exchange across the Straits. The FSC of Taiwan and CFRC of China held two meetings since they signed the Cooperation Agreement,²⁷⁾ and effectively exchanged opinions regarding Taiwan's entry into the Chinese market.

(3) The Implementation of the ECFA and Its Effect on Cross-Straits Trade and Investment

According to a study of the Chung-Hua Institution for Economic Research (CIER 2009), Taiwan's economy will grow by 1.65 ~ 1.72 percent after the signing of the ECFA and its subsequent trade agreements, and domestic GDP will increase by approximately US\$ 6.9 billion to US\$ 7.1 billion. It was also estimated that

26) The three MOUs were signed on December 7th, 2009.

27) The 2 meetings were held in April 2011 in Taipei and November 2011 in Beijing respectively.

gross industrial output value (including agriculture, manufacturing and services) will grow approximately 2.83 percent, or by approximately US\$ 28 billion; the total number of employment will grow 2.6 percent, or approximately 257,000 to 263,000 people.²⁸⁾

Another CIER study estimated that the potential benefits of the ECFA Early Harvest Program will increase Taiwan's GDP by 0.4 percent, or approximately US\$ 1.7 billion, following the implementation of the tariff reductions. The Gross industrial output value would grow by 0.86 percent, or approximately US\$ 5.7 billion. The Early Harvest Program of trade in goods will benefit most businesses in Taiwan, especially those in the petrochemical, machinery, textiles, auto parts, home electronics, and iron and steel sectors.

The services liberalization of the ECFA is expected to bring considerable economic benefits to Taiwan. The ECFA, if followed by further liberalization of the services trade agreement, will likely play a vital role in facilitating Taiwanese services enterprises to make their entry into the fastest growing services market in the world. In this regard, the ECFA may contribute to Taiwan's transformation from a manufacturing based economy to a services-driven knowledge-based economy. Some scholars have suggested, using estimates prepared by a Taiwanese bank, the annual pretax profits potentials for Taiwanese banks for expanded market access for Taiwanese enterprises alone for lending and wealth management services may come at a midpoint of US \$ 800 million, with a potential ceiling at US\$ 1.3 billion.²⁹⁾

According to the Ministry of Economic Affairs, in 2011 Taiwan's exports to and imports from China amounted to US\$ 84 billion and US\$ 44 billion, increasing by 9.1 percent and 21.3 percent relative to the previous year. The shares in total exports and imports are 27.2 and 15.5 percent respectively. If transit trade through Hong Kong is considered, Taiwan's total exports to the Mainland and

28) Available at the ECFA website, <http://www.ecfa.org.tw/EcfaAttachment/ECFADoc/1028-ECFA%20Win-Win%20Opportunities%20Tracked%20Changes.pdf>

29) Daniel H. Rosen and Zhi Wang, *The Implications of Taiwan-China Economic Liberalization*, Peterson Institute for International Economics, January 2011.

Hong Kong reached US\$ 124 billion, accounting for 40.2 percent of its total exports.

Both exports to and imports from the Mainland posted significant growth as a result of tariff reduction of the Early Harvest Program of the ECFA. According to Chinese customs statistics, in 2011 China imported a total of US\$ 19.9 billion worth of Early Harvest products from Taiwan; and estimated tariffs reduction (cost saved) were US\$122.6 million.³⁰⁾ On the other hand, Taiwan's customs statistics showed that Taiwan imported US\$ 5 billion in Early Harvest products from China, with total tariffs reductions reaching US\$ 22.8 million.

Among the Early Harvest products, transportation equipment and machinery grew by 46 and 29 percent compared to the previous year, showing the great potentials in the Chinese market. Other products such as petro-chemicals and textiles also grew by 8 percent respectively. As for agricultural products of the Early Harvest Programs, exports to the Mainland amounted to US\$ 125.6 million, an increase of 127 percent relative to the previous year. Exports of grouper (live) and Chinese green tea hit the record, exceeding US\$ 100 million respectively.

In 2011, total number of the Rules of Origin certificates for exports to China under the Early Harvest Program reached 41,000. There were 4,976 companies having applied for the ROO certificates, among which 2,829 companies have had no record of exports to the Mainland and were beginners in the Chinese market taking advantage of the ECFA preferential treatments. ³¹⁾

The ECFA also has significant implications on cross-Straits investment activities. In 2011 the Investment Commission of the MOEA, Taiwan, has approved 887 outbound investment projects aimed at the Mainland, total investment amount reaching US\$ 14.3 billion. However, this investment trend became much less phenomenal compared with the 2 digit growth rates in the earlier years.

In the meantime, the gradual change of Taiwanese investment in industries merits attention.³²⁾ In 2011, among the 5 main industries of investment, the

30) According to tariff reduction schedule, 76 items of Taiwanese exports China in 2011 were eliminated.

31) Press Release, Board of Foreign Trade, MOEA, Taiwan, Feb. 10, 2012.

electronics and chemicals remained the most heavily invested industries in the Mainland, while the financial services, for the first time in history, stood out as the 3rd largest industry for new investments. The investment amount of the financial services reached US\$ 1.24 billion, reflecting the expansion plans of 6 Taiwanese banks to set up their branches in the Mainland.³³⁾

Following financial services is retailing and distribution, with approved investments reaching US\$ 1.23 billion. It is believed that Taiwanese services enterprises in general take an aggressive stance in investing in the Mainland in order to take advantage of the Early Harvest Program of the ECFA and its subsequent negotiations of broader liberalization of cross-Straits services industry.

The gradual changes in investment scenarios imply the trend of Taiwanese FDIs in the Mainland. According to the Ministry of Economic Affairs, Taiwan has invested more than US\$ 100 billion in the Mainland in the past 20 years.³⁴⁾ A majority of the investment was concentrated in manufacturing, while investment in services industries remained around 6 percent of all FDIs in China. It was not until 2008 that the annual investment amount in services sectors in China has exceeded US\$ 1 billion for the first time. In 2008, the share of services in FDIs rose to 9.79 percent, and in 2009 continued to grow and reached 12.4 percent (See Chart 1).

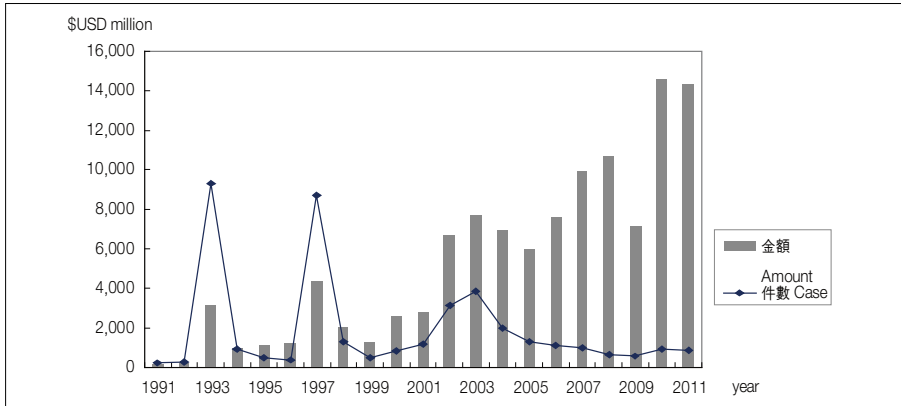
Since the concessions of the ECFA took effect, a growing number of Taiwanese services enterprises showed keen interest in exploring the Chinese market. The interest of these enterprises are partly attributed to the transformation

32) Press Release, Investment Commission, MOEA, Taiwan, Jan. 20, 2012.

33) These 6 banks are Mega Bank, China Trust Bank, Cathay United Bank, TCB, E. Sun Bank and Bank of Taiwan.

34) However, the government never had accurate statistical data as the Ministry of Economic Affairs has adopted a “Notification” principle that except certain strategically-sensitive industries such as high technology, Taiwanese companies are only required to report or notify the government of their Mainland investment proposals. Besides, this principle only applies to “direct investment” from Taiwan, which means that indirect investment via third country, usually the US, Singapore or Hong Kong, is not mandated for such notifications.

Figure 1. Statistics on Approved Mainland Investment Cases and Amounts



of the economy from one based on cheap labor and manufacturing to an emerging market of numerous middle-class and richer consumers who are willing to pay for higher living standard and better services. Another reason is that, as most services sectors in Taiwan tended to be more “inward looking” than “outward looking”, assisting services industries to “go abroad” has been on top of Taiwan government’s industrial policy. In this regard, the ECFA is instrumental in that it helps Taiwanese services providers to “go abroad” to explore the Chinese market.

It is also noteworthy that, since direct investments from the Mainland were allowed since June 2009, Taiwan has approved 2 applications of Chinese banks seeking to set up branches in Taipei, with the approved investment amount being US\$ 91.5 million, accounting for 33.62 percent of total approved amount of US\$ 272 million and ranking No. 1 in China’s inbound investment sectors.³⁵⁾ In addition to the fact that Chinese banks are encouraged by their government to develop overseas presence in Taiwan, the considerable business potentials of Taiwanese investors in the Mainland also attract Chinese banks for entry into Taiwanese market.

35) Press Release, Investment Commission, MOEA, Feb. 20, 2012.

Table 2. Statistics on Approved Mainland Investment By Industry

Industry	Food Manufacturing		Textiles Mills		Chemical Material Manufacturing		Chemical Products Manufacturing		Chemical Material Manufacturing		Chemical Products Manufacturing		Non-metallic Mineral Products Manufacturing		Fabricated Metal Products Manufacturing	
	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount
1991	18	19,208	17	21,503	2	1,298	6	1,609	2	1,298	6	1,609	12	5,714	11	9,164
1992	23	41,389	16	22,038	5	3,143	10	8,557	5	3,143	10	8,557	9	4,476	17	8,826
1993	685	276,883	312	140,780	156	68,878	371	90,482	156	68,878	371	90,482	413	185,438	619	196,462
1994	58	99,826	34	38,707	36	54,178	42	32,056	36	54,178	42	32,056	37	82,607	62	66,079
1995	30	109,047	17	58,929	13	75,280	15	11,286	13	75,280	15	11,286	19	47,016	39	103,687
1996	25	86,932	21	87,431	12	78,789	11	12,815	12	78,789	11	12,815	12	35,940	27	91,890
1997	1,005	269,599	273	179,624	176	88,105	337	124,434	176	88,105	337	124,434	570	383,641	594	335,710
1998	49	65,065	39	123,181	34	92,428	45	40,071	34	92,428	45	40,071	65	87,872	104	124,764
1999	17	52,511	9	29,543	19	85,573	14	53,132	19	85,573	14	53,132	14	33,752	25	96,734
2000	9	32,318	15	40,788	13	80,484	17	25,094	13	80,484	17	25,094	8	83,524	44	138,295
2001	22	42,310	19	37,452	14	123,005	23	31,209	14	123,005	23	31,209	15	106,981	83	149,140
2002	82	115,393	60	144,435	110	373,199	82	82,892	110	373,199	82	82,892	93	214,841	203	540,145
2003	95	296,404	114	341,792	85	463,441	114	105,112	85	463,441	114	105,112	121	451,416	297	548,706
2004	31	71,394	39	150,115	37	358,282	42	77,418	37	358,282	42	77,418	47	421,313	113	638,210
2005	26	46,946	28	148,479	25	299,109	32	60,290	25	299,109	32	60,290	23	179,576	107	542,218
2006	18	71,592	32	110,092	26	399,901	21	138,369	26	399,901	21	138,369	23	386,827	77	442,483
2007	13	63,619	24	103,361	2	141,645	7	107,609	2	141,645	7	107,609	23	231,452	60	309,437
2008	24	188,753	7	103,342	5	443,439	8	31,240	5	443,439	8	31,240	14	223,749	25	297,795
2009	39	336,957	10	60,934	11	212,440	7	79,130	11	212,440	7	79,130	11	194,146	23	215,952
2010	47	198,217	12	114,602	6	187,926	6	56,807	6	187,926	6	56,807	24	791,772	28	407,248
2011	17	202,935	10	84,177	27	832,680	14	203,047	27	832,680	14	203,047	29	555,177	30	396,990
Total	2,333	2,687,298	1,108	2,141,305	814	4,463,222	1,224	1,372,659	814	4,463,222	1,224	1,372,659	1,582	4,707,230	2,588	5,659,935

(Unit: US\$1,000)

Table 2. Continued

(Unit: US\$1,000)

Industry	Electronic Parts and Components Manufacturing		Machinery and Equipment Manufacturing		Wholesale and Retail Trade		Information and Communication		Financial and Insurance		Real Estate	
	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount
Year	12	4,995	9	8,588	1	200	0	0	0	0	0	0
1991												
1992	1	1,528	4	5,546	0	0	0	0	0	0	0	0
1993	285	110,666	303	86,346	170	70,755	15	3,340	15	1,963	3	2,083
1994	35	40,769	57	49,023	31	21,136	5	2,558	1	28	0	0
1995	21	101,889	21	45,008	32	56,190	4	1,475	1	100	0	0
1996	20	88,429	23	54,894	23	30,285	2	11,200	5	11,799	2	4,876
1997	369	283,525	424	202,660	287	124,902	26	4,601	37	62,629	2	5,126
1998	73	281,402	88	118,900	47	85,370	18	9,871	5	1,031	1	670
1999	51	154,029	27	44,081	26	19,748	12	7,347	1	18,210	2	1,225
2000	104	412,348	38	72,545	45	57,916	46	53,491	0	0	0	0
2001	191	600,559	73	130,442	110	117,211	106	55,077	16	3,162	1	350
2002	209	1,087,523	200	286,238	199	146,957	132	88,028	28	71,559	1	90
2003	201	815,821	245	328,088	255	175,404	86	65,402	30	82,605	60	197,011
2004	121	1,482,225	129	213,734	320	183,070	97	51,222	16	69,877	13	15,738
2005	62	850,106	99	352,940	143	274,288	79	106,252	14	35,063	5	13,300
2006	94	1,618,566	75	214,726	150	312,778	43	81,166	7	84,434	5	17,803
2007	197	2,426,286	56	504,199	138	411,902	62	151,269	12	117,948	5	13,647
2008	169	2,051,917	20	473,594	72	499,106	58	324,465	6	255,623	1	28,960
2009	123	1,801,294	32	394,518	82	743,150	27	106,845	3	48,717	1	17,200
2010	164	4,854,424	31	502,675	166	1,115,494	32	333,066	12	500,376	38	1,128,284
2011	149	3,467,195	34	534,324	149	1,232,720	23	282,532	27	1,255,828	19	413,598
Total	2,651	22,535,495	1,988	4,623,068	2,446	5,678,582	873	1,739,207	236	2,620,952	159	1,859,961

III. Taiwanese Banks in China: First Year's Review

(1) Chinese Liberalization Commitments in Banking Sector

The liberalization of Chinese financial market has come a long way. In 1979, Japan Export and Import Bank³⁶⁾ opened its representative office in Beijing and became the first foreign bank permitted by the People's Republic China to set foot in the Mainland. In 1994, the PRC government passed its first law for the regulation of foreign financial institutions in the country.³⁷⁾ In the following 4 years, the number of foreign financial institutions and their branches and subsidiaries reached 164. The door then closed in 1998 when China began to adopt a more protective approach in response to the Asian financial crisis spreading in Asia.

China applied for its membership to the General Agreement on Tariffs and Trade (GATT) in 1986, and on December 11th of 2001, became the 143rd member of the World Trade Organization (WTO). In addition to committing to comprehensive liberalization of trade in goods, China had agreed to liberalize more than 90 services sectors and sub-sectors, including telecommunications, banking, insurance, transportation and distribution, among others.³⁸⁾

In banking services,³⁹⁾ China had agreed to make concessions in Mode 3 to improve commercial presence by foreign banking services and services providers. These include elimination of limitations of geographic coverage and client coverage.

36) The Bank then merged with Japanese Fund of Overseas Economic Assistance in 1999 and renamed as Japan Bank for International Cooperation (JBIC).

37) The name is "The Rules on Administration of Representative offices of Foreign Financial Institutions in the People's Republic of China."

38) Press Release/243, 17 September 2001.

39) Banking services here include: a. Acceptance of deposits and other repayable funds from the public; b. Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction; c. Financial leasing; d. All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts(including import and export settlement); e. Guarantees and commitments; and f.Trading for own account or for account of customers: foreign exchange.

There will be no geographic restriction for foreign currency business upon China's accession, while the geographic restriction for RMB business shall be phased out within 5 years after its accession.⁴⁰⁾ It means that by end of 2006, all foreign banks and financial institutions in the country will be allowed to operate RMB business in any cities in the Mainland.

With respect to client coverage, there will be no client restrictions for foreign currency business in China upon accession, while for RMB business, foreign financial institutions will be permitted to provide services to Chinese enterprises within 2 years after accession; and will be permitted to provide services to all Chinese clients (including Chinese citizens) within 5 years after accession.⁴¹⁾

China has also agreed to eliminate any existing non-prudential measures restricting ownership, operation, and juridical form of foreign financial institutions, including on internal branching and licenses, within 5 years after accession. However, foreign financial institutions will have to meet specific requirements: in order to establish a subsidiary or a foreign finance company in China, total assets of more than US \$10 billion is needed at the end of the year prior to filing the application; in order to establish a branch in China, total assets of more than US \$ 20 billion at the end of the year prior to application; in order to establish a Chinese-foreign joint bank or a joint finance company in China, total assets of more than US \$10 billion at the end of the year before application. In addition, in order for foreign financial institutions to engage in RMB business, applicant foreign institutions should have been operating in China for a minimum of 3 years and being profitable for 2 consecutive years prior to the application.⁴²⁾

40) WT/ACC/CHN/49/Add.2, 1 October 2001. The geographic restriction for RMB business will be phased out as follows: Upon accession, Shanghai, Shenzhen, Tianjin and Dalian; Within 1 year after accession, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan; within 2 years after accession, Jinan, Fuzhou, Chengdu and Chongqing; within 3 years after accession, Kunming, Beijing and Xiamen; Within 4 years after accession, Shantou, Ningbo, Shenyang and Xi'an. Within 5 years after accession, all geographic restrictions will be removed.

41) *Ibid.*

42) *Ibid.*

China had also agreed to liberalize other financial services, which include: provision and transfer of financial information, and financial data processing and related software by supplier of other financial services; advisory, intermediation and other auxiliary financial services, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy. In the criteria for authorization, all measures adopted will be solely prudential and will not contain economic needs test or quantitative limits on licenses.

The coverage of China's accession commitments and level of their openness were often praised and described by some scholars and experts as "breathtaking" or "the most radical" among all new WTO members. The ambitious commitments to comprehensive liberalization was a part of Chinese government's wider development strategy of reforming major services sectors and demonstrated China's determination.

Despite the fact that China had adopted a restrictive regime for foreign banks before it was admitted to the WTO,⁴³⁾ it was estimated that by early 2000 foreign banks and financial institutions had already established altogether more than 190 subsidiaries, branches and representative offices in the country with their assets totaling US\$ 36 billion.⁴⁴⁾ In addition, during China's accession negotiations, a number of foreign or joint venture banks had already received licenses as part of the implementation of China's WTO commitments. These included the Bank of East Asia, Citibank, Hang Seng Bank, HSBC, and Bank of Standard Chartered. Rights to offer RMB lending to foreign companies and individuals had also been extended beyond regional pilot programmes. These foreign banks, mainly from Europe, the United States and Hong Kong, had gained significantly advantageous positions in Chinese market, while other foreign banks had to wait till Chinese

43) Namely, foreign banks were not allowed to operate RMB business with foreign businesses or individuals. There were also strict geographical restrictions as to the establishment of foreign banks and their branches.

44) Lin Tinghuan, The entry of foreign banks into the Chinese banking sector, BIS Paper No. 4.

banking sector gradually opened up as China implemented its WTO commitments.⁴⁵⁾

Between 2001 and 2006, it was estimated the number of foreign branches and subsidiaries in China increased from 177 to 253, and their total assets of operations increasing by 95 percent.

(2) Further Liberalization Since 2006

China Banking Regulatory Commission (CBRC) was officially launched on 28 April 2003. On November 11, 2006, the State Council promulgated the *Regulations of the People's Republic of China on Administration of Foreign-funded Banks* (hereinafter referred to as the *Regulations*).⁴⁶⁾ Accordingly, the CBRC promulgated the *Rules for Implementing the Regulations of the People's Republic of China on Administration of Foreign-funded Banks* (hereinafter referred to as the *Rules*) on November 24, 2006. According to the *Regulations*, the geographic and clients restrictions on RMB business of foreign banks were removed. For RMB business, foreign banks may expand their clients to Chinese citizens with no geographic restrictions. Besides, the foreign bank branches having been incorporated may receive deposit of no less than RMB1 million Yuan each time from Chinese citizens.

These rules stipulate the “Locally Incorporation Policy” as a major guideline for foreign financial institutions in the Mainland. The “Locally Incorporation Policy” is a policy to promote “locally incorporated institutions (LII)” of foreign banking institutions in the Mainland. On April 2, 2007, Citi China became a locally incorporated bank in China, one of the first foreign banks to do so.⁴⁷⁾ Since the policy was

45) John Whalley, *Liberalization in China's Key Services Sectors Following WTO Accession: Some Scenarios and Issues of Measurement*, December 2003.

46) The *Rules on Administration of Representative offices of Foreign Financial Institutions in the People's Republic of China* promulgated by the People's Republic of China on June 13, 2002 is no longer effective.

47) As a locally incorporated bank, Citi China's legal name thus changed to Citibank (China) Co.

in place, branches of foreign banks have been encouraged to transform into subsidiaries, either 100% foreign owned or foreign-Chinese joint ventures.

The CBRC announced on 24 December 2006 its approval for 9 foreign-funded banks to begin preparations for setting up local corporations in China.⁴⁸⁾ The number of branches of these 9 banks then accounted for 34 percent of total branches of all foreign-invested banks in the Mainland, with their registered capital and profits accounting for 55 and 58 percent respectively of all branches of foreign-invested banks in the Mainland.⁴⁹⁾

The local incorporation policy has become the main choice for foreign banks. In October 2000, there were 234 representative offices of foreign banks, 157 foreign bank branches and 13 locally registered foreign banks subsidiaries and joint ventures in China. In September 2011, the numbers increased to 39 foreign banks (with 247 branches and auxiliary agencies), 1 foreign finance company, 93 branches and 207 representative offices. The country origins of the foreign financial institutions cover 47 countries and regions, including Russia, Sweden, Norway, Spain, Egypt, India and Indonesia, not to mention those from North America, Europe, Hong Kong and Singapore. Moreover, business scope of these banks has gradually expanded to micro finance, agriculture finance, aircraft finance, commodity trade finance, assets and wealth management, trust and settlement.⁵⁰⁾

The local incorporation policy is believed to help safeguard Chinese financial markets from risks such as those during the global financial crisis in 2008, as the assets and businesses become immune to bankruptcy crisis of their parent banks. According to CBRC, in 2011 total assets of foreign banks in the Mainland reached US\$ 2.06 trillion, increasing by a compound growth rate of 19% as compared with the US\$ 373 billion before 2002. Since the outbreak of the global financial crisis

48) These 9 banks are Standard Chartered Bank (United Kingdom), The Bank of East Asia (Hong Kong), The HSBC (Hong Kong), Hang Seng Bank (Hong Kong), Mizuho Corporate Bank (Japan), The Bank of Tokyo-Mitsubishi UFJ (Japan), DBS Bank (Singapore), Citibank (United States) and ABN AMRO (Netherlands).

49) Wen Wei Po, Dec. 26th, 2006.

50) Ten Years of Liberalization of Chinese Banking Sector (in Chinese), CBRC, Dec. 16th, 2011.

in 2008, more than 40 foreign banks in the Mainland invested an additional RMB 280 billion Yuan as their registered or operational capital. The average Non-Performing Loans (NPL) rate of foreign banks is 0.41 percent, lower than the average NPL of domestic banks. Foreign banks in China created more than 240 different financial products, and enjoy a market share of 34.6 percent of the emerging market of financial derivatives, next only to that of China's 5 major state-owned commercial banks.⁵¹⁾

In December 2011, the CBRC released a review of 10 years of the Chinese banking sector after it was admitted to the WTO and concluded that foreign banks have successfully “localized” and “tailored” their services to domestic needs. The RMB business has grown significantly for foreign banks. 35 foreign banks and 45 foreign bank branches were given approval to operate RMB business. RMB-assets make up of more than 70 percent of their assets now while it was only around 12 percent in the pre-WTO period. The CBRC also found foreign banks have expanded their local client base over the past years, a sharp contrast to their heavy reliance on foreign corporate clients and expatriates and very few Chinese corporate clients. It is estimated that Chinese clients, including corporate and citizens, comprise 54 percent of their client base, and 37.89 percent of their loans, an increase of 31 percent compared with the pre-WTO period. With regards to employment, foreign banks employ around 33,000 local Chinese people, also more than 45 percent of their managerial staff being local talents.⁵²⁾

(3) Comparison between the ECFA and the CEPA

The proliferation of Free Trade Agreements (FTAs) and Regional Trading

51) The 5 state-owned commercial banks include the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, China Construction Bank, and the Bank of Communications.

52) Ten Years of Liberalization of Chinese Banking Sector (in Chinese), CBRC, Dec. 16th, 2011.

Agreements (RTAs) since the late 1990s, particularly in the Asia Pacific region, has a profound influence on China's external policy after its accession to the WTO. In order to further strengthen its external trade and investment relations with selected trading partners, China began to pursue RTAs and has so far concluded 10 FTAs or similar trade agreements.⁵³⁾

China and Hong Kong, Macao signed a Closer Economic Partnership Arrangement (CEPA) in June 2003 and October 2004 respectively. Since then, both sides have negotiated and signed Supplement I ~ VII to CEPA to gradually expand specific commitments to realize the China-Hong Kong and China-Macao Free Trade Areas. According to the Ministry of Commerce, China has granted market access to 148 sectors and sub-sectors of Hong Kong's services industry, providing Hong Kong the highest degree of services liberalization Chinese government has ever given to its trading partners.

Soon after the CEPA was signed between China and Hong Kong in June 2003, CBRC and Hong Kong Monetary Authority (HKMA) signed a Memorandum of Understanding aiming to strengthen banking supervision cooperation of banking sector from two sides. The MOU also provided a legal base for Hong Kong financial institutions for setting foot in the Mainland as required by Chinese law. In Supplement IV, VI and VII, specific preferential treatments are listed for Hong Kong's banking, securities and futures industries in exploring the Chinese market. For example, the Supplement VII was signed between China and Hong Kong on May 27, 2010, and entered into force on January 1, 2011. In the Supplement, two sides have agreed to accelerate liberalization of financial services and will allow a Hong Kong bank that has maintained a representative office in China for more than one year to apply to set up a wholly foreign-funded bank or a foreign bank branch. Operating institutions of Hong Kong banks in China can apply to conduct RMB business, if they have been operating for more than two

53) See China FTA Networks Website supported by Ministry of Commerce, China, <http://fta.mofcom.gov.cn/english/index.shtml>

years and were profitable for one year prior to the application.

CEPA was highly welcomed by the Hong Kong business community. The HKMA also regarded CEPA as offering many market access opportunities and flexibility for Hong Kong's financial services suppliers and professionals. Particularly, for the banking sector, Supplement IV has lowered the asset requirement substantially for Hong Kong banks, from US\$ 20 billion to US\$ 6 billion for setting up Chinese branches. The concessions in CEPA, particularly the lowering of the asset requirement, give Hong Kong banks a comparative advantage. In fact, among the most successful foreign banks in the Mainland, the HSBC, Bank of East Asia and Hang Seng Bank from Hong Kong are ahead of most of their competitors in both client base and branch networks in the Mainland.⁵⁴⁾

Along with China's policy of RMB internationalization, it will create tremendous opportunities for all banks serving traders and investors in the Mainland. Initially the main beneficiaries will be Chinese domestic banks and Hong Kong banks, and foreign banks with presence in the Mainland and Hong Kong. The rapid development of Hong Kong as the offshore RMB center and China's policy to promote Hong Kong as an international financial center will definitely bring significant benefits to Hong Kong.

However, to realize the effects of the CEPA and the ECFA, it would be important to examine how "different" a country's differential treatments are to its FTA trading partners vis-à-vis non-FTA countries. In another words, it is important to find out if the FTA treatments are significantly better than the Most Favored Nation treatments given to all other WTO members. The answers vary depending on the country and FTA. However, some scholars find a general trend of FTAs or PTAs (Preferential Trade Agreements) commitments going beyond GTAs offered under the WTO, with a few exceptions, for example, China and India, among others.⁵⁵⁾ China tends to take commitments already made under

54) For details, please refer to *Foreign Banks in China*, PwC, June 2011.

55) For example, see Martin Roy and Juan Marchetti, *Services Liberalization in the New Generation of Preferential Trade Agreements (PTAs): How Much Further than the GATS?* WTO Staff

GATS schedules or accession concessions. Therefore, it is not a surprise to find that, in the FTAs signed between China and other countries, with CEPA and ECFA as only exceptions, China has intended to keep its commitments identical with its WTO obligations. In this sense, China provides better treatments to Taiwan than its other FTA partners in most of the services sectors covered by the Early Harvest Programs.

In the banking sector, for example, Taiwanese banks are given shorter period before they apply to set up branches (2 years) and lower profitability assessment (1 year before the application). In addition, as Taiwan is a latecomer in the Chinese market, China has agreed for Taiwanese banks to apply for RMB business for Taiwanese businesses or investors after they have been operating in the Mainland for one year and make profits. China's other FTA partners, such as ASEAN, have to wait for 3 years before their representative offices become full branches, and another 2 years to conduct RMB business with the year before the application making profit, same as China's commitments in the WTO.

It is crystal clear that China has a political reason to provide Taiwan, Hong Kong and Macao better treatments than its other FTA partner countries, including its important neighbors in ASEAN. The question raised here is whether the treatments are significantly different between the CEPAs with Hong Kong and Macao and the ECFA. Taking the banking sector as an example again, the Supplement VI to CEPA stipulates that the asset requirement to set up branches in the mainland for Hong Kong banks is US\$ 6 billion, while in the ECFA Taiwanese banks have to satisfy a US\$ 20 billion requirement as other foreign banks. The asset requirement to set up 100% foreign-funded banks in the Mainland has also been lowered for Hong Kong banks from US\$ 10 billion to US\$ 6 billion, while the requirement for Taiwanese banks is US\$ 10 billion. As a majority of Taiwanese banks are small in size, the US\$ 20/10 billion requirements may become

Working Paper, Sep. 2006. John Whalley, LIBERALIZATION IN CHINA'S KEY SERVICE SECTORS FOLLOWING WTO ACCESSION: SOME SCENARIOS AND ISSUES OF MEASUREMENT, NBER WORKING PAPER 10143, Dec. 2003.

serious barriers for their entry into the Chinese market.

It is also worth noting that just a month before the ECFA was signed in June 2010, the Supplement VII to CEPA was consulted and signed on May 27, where China has agreed to give Hong Kong the same treatment, a shorter period and lower requirements. It is also not pure coincidence that China meant to sign the ECFA on June 29, the same date as the CEPA was signed in 2003.

In a comparison of the CEPA and the ECFA, one may conclude that China seems to provide better treatment to Hong Kong (and Macao) over Taiwan, or at least it appears to be so in the banking sector. As the ECFA is only a Framework Agreement that will be followed by more comprehensive liberalization of both goods and services, it is understandable that China will be hesitant to provide any significantly preferential treatments to Taiwan in the initial stage of the negotiations. However, Taiwan should try to negotiate better terms with China in subsequent services negotiations, which may include, for example, asking for China to lower asset requirements for Taiwanese banks.⁵⁶⁾

(4) Taiwanese Banks in China

(4-1) A brief review of Taiwan's policy of cross-Straits banking

Despite the fact that Taiwanese investors began to set foot in the Mainland since the 1970s and were among the earliest “pioneers” to trade with and invest in China, Taiwan's strict restrictions over cross-Straits interaction has seriously hindered Taiwanese banks in their following their Taiwanese clients into China and providing banking services. The restrictions have also prevented Taiwanese banks from going to China setting up networks, pushing them 10 to 20 years behind other major Western and Asian banks in the Mainland.

56) For example, after the ECFA was signed, China has expressed that the future Cross-Strait negotiation will be based on reciprocity and its consideration of domestic economic benefits on more than one occasion.

Taiwan's cross-Straits financial policy can be briefly divided into four stages: the "Non-governmental Interaction Period" between 1987 and 1992; the "Indirect Engagement Period" between 1993 and 2000; the "Direct Engagement: Active Opening and Effective Management Period" between 2001 and 2008; and the "Direct Engagement: Moving Toward Liberalization Period" since May 2008 till the present.⁵⁷⁾

Since 1987 when Taiwanese government lifted the ban prohibiting Taiwanese citizens from visiting the Mainland, the cross-Straits relations moved from the four decades of "No Contact" to a "Non-governmental Interaction Period". During this period, Taiwanese banks were allowed to conduct foreign reserve remittance through Standard Charter Bank to the Mainland for humanitarian purpose (Taiwanese citizens to remit money to their relatives in the Mainland), which then expanding to purpose of trade financing.⁵⁸⁾

The "Indirect Engagement Period" was launched in April 1993, when the government for the first time passed a regulation lifting a ban prohibiting overseas branches of Taiwanese banks from conducting business with overseas branches of Chinese banks and branches of foreign banks in the Mainland. Faced with increasing pressure from the business community to relax restrictions on cross-Straits trade and investment, in June 2001, then President of Taiwan Mr. Chen Shui-bian decided to fine-tune the "No haste, Be patient"(戒急用忍) principles set by his predecessor Dr. Lee Teng-hui and allowed Taiwanese banks, among a series of other relaxation measures, to set up representative offices in the Mainland. In March 2008, Chen's administration further relaxed indirect investment in the Mainland by allowing local financial holding companies and overseas subsidiaries of Taiwanese banks to acquire minority stakes in Chinese banks, in principle no more than 20 percent, in order to strengthen the banks' international competitiveness.

57) For details please see the FSC materials, <http://www.fsc.gov.tw/ch/home.jsp?id=138&parentpath=0,4>

58) For example, to support the emerging business model of Taiwanese trading companies "taking orders in Taiwan and manufacturing in the Mainland."

(4-2) Latest Development

President Chen's "Active Opening and Effective Management" period ended with President Ma winning the Presidential election and taking office in May 2008. In announcing his new cross-Straits policy, President Ma put forward his plan to negotiate an ECFA for enhancing broad interaction with the Mainland.

President Lee and President Chen's cross-Straits policy were often criticized as obstacles to Taiwan's economic development because they discouraged direct economic engagement with the Mainland. With regard to the financial sector, as a result of the no direct engagement policy adopted by the two administrations, Taiwanese banks were prohibited from setting up branches or subsidiaries in the Mainland. Therefore, when other foreign banks, including Western banks and Asian banks, actively made their way in the Chinese market since the late 1990s, Taiwanese banks had been absent. The only exceptions were two joint venture banks with Taiwanese capital, the Sino First Bank (華一銀行) and the Concord Bank (協和銀行), which became operational in Shanghai and Ningbo in the 1990s and are regarded to be the first Taiwanese banks in China in the form of joint ventures. Targeting Taiwanese investors in the Mainland, the Sino First Bank and the Concord Bank have grown their business amidst sizable competition.

What is even more detrimental, the absence of Taiwanese financial institutions in the Mainland made funding for trade and investment more difficult and costly for most Taiwanese investors. According to a survey by UBS in 2007, more than 80% of Taiwanese investors, whether listed companies or smaller ones, considered funding a major obstacle when investing in China. They would turn to a Taiwanese bank only when they were allowed to, for obtaining loans.

Tied up in the government's strict Cross-Straits investment policy, the Fubon Financial Holding Company⁵⁹⁾ made an "indirect" entry into China through Hong Kong by acquiring majority stakes of a Hong Kong bank in 2004 and set up

59) The Fubon Financial Holding Company is Taiwan's second largest financial holding company; its business includes banking, insurance, securities and asset management.

Fubon Bank (Hong Kong) Limited. Using the Hong Kong bank as a vehicle, in 2009 Fubon acquired stakes of Xiamen Bank and hence was able to set up branches in Fuzhou (Fujian Province), Quanzhou (Fujian Province) and Chongqing. Fubon is by now the only Taiwanese bank with a stake in a Chinese bank.⁶⁰⁾

Fubon was a successful yet rare case. The other Taiwanese banks had to wait for a green light from the government. In June 2001, the Chen administration announced that it was relaxing the ban and allowed Taiwanese banks to apply to set up representative offices in the Mainland. In March 2002, 8 major Taiwanese banks submitted applications to their representative offices.⁶¹⁾ Among them, the state-controlled Taiwan Cooperative Bank (TCB) set up its representative office in Shanghai in 2002 and became the first Taiwanese bank to establish a presence in the Mainland. The China Trust Commercial Bank launched its Beijing representative office later in January 2003, ahead of its peers of privately-owned banks in Taiwan.

In 2006 China adopted a new policy and hence for almost 8 years these representative offices could not apply for upgrade to full branches, pending an official MOU of financial supervision cooperation across the Strait. Therefore, in 2009 when the MOU was signed by the CBRC and the FSC, all Taiwanese financial institutions, particularly these banks with representative offices in the Mainland, see direct benefits from the historic progress.

As of January 2012, the FSC has approved 11 Taiwanese banks of their applications of establishing branches in the Mainland. Among them, 7 banks have opened their first branch and applied to set up their second branch or sub-branch.

60) The Fubon model aroused hot debates in Taiwan about its “compliance” with the government’s Cross-Straits policy. It is the first Taiwanese bank to set foot in Hong Kong and the first to have operations in Taiwan, Hong Kong and the Mainland. For details, see the company’s website, <http://www.fubon.com/financial/financial-about/000financial-about-12.htm#01>.

61) First Commercial Bank, Cathay United Bank, and The Land Bank of Taiwan applied to set up rep. offices in Shanghai. Chang Hwa Bank and the International Commercial Bank of China (ICBC) applied for their Kunshan and Suzhou rep. offices, while Huanan Bank, Taiwan Cooperative Bank and Chinatrust chose Shenzhen for their rep. offices.

Apart from these branches, 8 representative offices are waiting to be upgraded. (See Table 3)

Most Taiwanese banks chose to set up their first branch in Shanghai, Suzhou, Kunshan and Shenzhen, the four major destinations of Taiwanese investment and expatriate communities. Following setting up branches in Shanghai, their subsequent plans tend to involve diversification to other areas, such as Tianjin, Chengdu and Qingdao. All Taiwanese banks consider RMB business key to their expansion of business in the Mainland.

For example, a lot of Taiwanese banks are eager to set foot in the “Great West” of China in order to provide services to a growing number of Taiwanese investors in Sichuan (四川) and the neighboring areas. As of January 2012, the number of registered companies of Taiwanese origin in Chengdu reached 878, with total investment amount reaching US\$ 4.98 billion, mainly in electronics, food and beverage, building materials, retails and agriculture.

Nowadays, most Taiwanese banks are beginning to establish their presence in the Mainland after coming a long way of dealing with different government policies and bureaucracies. The Cathay United Bank (CUB, 國泰世華銀行),⁶²⁾ First Commercial Bank (FCB, 第一商業銀行),⁶³⁾ Land Bank of Taiwan (TLB, 台灣土地銀行) and China Trust Commercial Bank (CTCB, 中國信託商業銀行)⁶⁴⁾ have finally opened their Shanghai branches. The FCB opened its Branch in December 2010, making it the first Taiwanese bank to initiate formal business operations in the Mainland.

62) Cathay United Bank is a wholly owned subsidiary of Cathay Financial Holding Company, the largest financial holding company in Taiwan. The Bank is a full-service bank serving consumers and businesses with over one hundred domestic branches and over ten overseas offices.

63) First Commercial Bank completed its privatization process for Taiwan Provincial Government in January of 1998 and became the largest private commercial bank in Taiwan.

64) Formerly known as China Securities Investment Corp., Chinatrust Commercial Bank was established in 1966. In late 2010, it had a total of 146 offices in Taiwan and 66 locations (branches, subsidiaries and their branches, and representative offices) abroad, the most of any Taiwan-based bank.

Table 3. Taiwanese Banks in China (as of March 1st of 2012)

Bank	Branch and Sub-branch		Rep. Office
	Operational	Further plans	
First Bank	Shanghai Branch	Will open Chengdu Branch by end of 2012 Will apply for 3rd branch	—
Cathay United Bank	Shanghai Branch	Will open Minhang(閔行) Sub-branch of the Shanghai Branch Will apply to set up Qingdao branch	—
CHB	Kunshan branch	Will open Huaqiao (花橋) Sub-branch of Kunshan Branch	—
TLB	Shanghai Branch	Will open Tianjin Branch	—
Taiwan Collective Bank (TCB)	Suzhou Branch	Will open Tianjin Branch and Gaoxin Sub-branch of Suzhou Branch	Beijing Rep. Office
Hua Nan Bank (HNCB)	Shenzhen Branch	Will open Shanghai Branch and Baoan (寶安) Sub-branch of Shenzhen Branch	—
China Trust Commercial Bank (CTCB)	Shanghai Branch	—	Beijing Rep. Office
Mega International Commercial Bank (MEGA)	—	Will open Suzhou Branch	Suzhou Rep. Office
Bank of Taiwan (BOT)	—	Will open Shanghai Branch	Shanghai Rep. Office
E.SUN Bank	—	Will open Dongguan Branch	Dongguan Rep. Office
Taiwan Business Bank (TBB)	—	Will open Shanghai Branch in 2012	Shanghai Rep. Office
Bank SinoPac	—	—	Nanjing Rep. Office
Taipei Fubon Bank	—	—	Soochow Rep. Office
Taiwan Industrial Bank	—	—	Tianjin Rep. Office

Sources: compiled by the author.

By the end of 2012, two other banks, Bank of Taiwan (BOT, 臺灣銀行) and Taiwan Business Bank (TBB, 臺灣企銀), are expected to join and by then the competition in Shanghai financial market will be even more fierce. The Chang Hwa Bank (CHB, 彰化商業銀行),⁶⁵⁾ Taiwan Cooperative Bank (TCB, 合作金庫銀行)⁶⁶⁾ and Hua Nan Bank chose to set up their first branch in Kunshan, Suzhou or Shenzhen in order to serve their Taiwanese clients more conveniently.

In addition to the representative offices that are awaiting approval for conversion to branches, those with Chinese branches in operation are waiting for the license to conduct RMB business. Moreover, after serving Taiwanese clients in the initial stage, these branches plan to expand to small- and medium-sized enterprises (SMEs) and then gradually develop in local market. Currently, the TCB's Suzhou Branch, established in 2011 with the yearly profits of over US\$ 2 million, has successfully expanded to RMB business in early 2012. The majority of other Taiwanese banks will very likely to follow suit due to their profitable performance in the first year. For example, China Trust set as its target a profit of US\$ 6 million for its Shanghai Branch, opened 9 years after its representative office set up in early 2003, in its first year. It expects to take advantage of the ECFA and apply for RMB business for Taiwan-funded enterprises by early 2014.⁶⁷⁾

As for other financial sectors, 13 Taiwanese securities companies have set up 25 representative offices. 2 investment companies have set up their representative offices, while 4 companies have already gained approval to set up joint venture fund management companies in the Mainland. As for the insurance

65) In December 1997, the Taiwan provincial government made public its shareholdings in CHA in line with the government's policy of financial privatization. The Bank was officially privatized on January 1, 1998. The Bank is one of the leading commercial banks in Taiwan in terms of paid-in capital and sound financial structure.

66) TCB was established in 1946 and achieved corporate status in May 1985. TCB went public in June 2003. In 2009, TCB was ranked 160 by asset size in the top 1000 banks in the world, second only to Bank of Taiwan in its home country.

67) The Bank's Shanghai Branch will be officially opened on March 27, 2012. United Daily, March 21, 2012.

sector, the Investment Bureau of the FSC has given green light to 9 Taiwanese insurance companies to enter the Chinese market by acquiring stakes in their Chinese partner companies. 6 of them are already engaged in business operations in China, while there are 15 representative offices waiting for approval.⁶⁸⁾

(4-3) Chinese Financial Market: Opportunities and Challenges for Taiwan

The ECFA provides enhanced market access for the banking sector and for creating growth opportunities for both Taiwan and China. There are currently 37 commercial banks and other financial institutions in Taiwan. For Taiwanese banks that are facing saturation pressure in the domestic market, going to China will greatly expand the total available market. Taiwanese investors in the Mainland will also benefit significantly from access to their home bankers and capital services at a manageable cost, particularly the SMEs that have problems in funding from Chinese or foreign banks in the Mainland.

Given all the opportunities, however, Taiwanese banks are also faced with challenges and unpredictable risks in the Chinese market. Being a late comer, Taiwanese banks have to catch up with their competitors, including China's major state-owned banks, the much more experienced Western and Japanese, Hong Kong and Singaporean banks in competing for clients. For example, the HSBC has had a continuous presence in China for more than 140 years, with a network of 106 outlets in 27 cities in the country. In addition, with nearly 7,000 outlets in the world, the HSBC can also offer Chinese enterprises local services as they gradually go overseas in recent years; while Taiwanese banks are only beginning to set foot in Chinese market with very limited number of branches and sub-branches and even less access to operation of RMB business. What Taiwanese banks could offer to potential Chinese clients would be very limited.

68) Press Release, Commission of Mainland Affairs, Jan. 27, 2012, <http://www.mac.gov.tw/ct.asp?xItem=100972&ctNode=6409&mp=1>

Apart from the fierce competition, the Taiwan government still maintains a restrictive policy towards cross-Straits financial interaction and banking cooperation even after the financial supervision cooperation MOUs and the ECFA were signed between the two sides. For example, the FSC still maintain regulations that Taiwanese banks may establish representative offices, branches or subsidiary banks and make equity investment in the Mainland, but can only engage in two of the 3 activities: establish branches, establish subsidiary banks, and make equity investment.

IV. Conclusions

This paper examines progress across the Strait and the ECFA in its background and content for liberalization of Cross-Straits banking, and then explores the opening up of China's financial market by its concessions under the WTO and concessions under the CEPA with Hong Kong; and makes a comparison between the ECFA and the CEPA. In the third part, the paper reviews the effect of the ECFA on its first anniversary, and then analyzes the opportunities and challenges faced by Taiwanese banks in further exploring the Chinese market.

The paper finds that including the banking sector (and other services sectors) in the Early Harvest Program of the ECFA; a rare, if not the only, practice in most FTAs; has helped Taiwanese banks to set foot in the Chinese market after years of prohibition by national policy of both Taiwan and the Mainland. The immediate effect can be found in the number of Taiwanese banks applying to set up representative offices, branches, and sub-branches in the Mainland in the first year of implementation of the ECFA. It is estimated that except those financial institutions that fail to meet the asset requirement of China in setting up subsidiaries in the Mainland, almost all Taiwanese banks have made strategizing moves into the Chinese market an important step in their business development. Meanwhile

the smaller financial institutions are trying to lobby the government to insert a preferential clause in future Cross-straits negotiation to lower the asset requirements of US\$ 10 billion and US\$ 20 billion to US\$ 6 billion as Hong Kong banks enjoy in the Supplement to the CEPA. As China shares the same language and culture and has more than 100,000 Taiwanese enterprises investing in the Mainland, China becomes a priority and niche market if Taiwanese banks, big or small, plan to go international.

However, the ECFA has provided Taiwanese banks limited preferential treatment except a shorter waiting period and lower profitability requirement. As for the most needed relaxation of asset requirements as Hong Kong and Macao banks have enjoyed through Supplement to CEPA, it is not included in the ECFA. According to scholars who find that China tends not to include new binding commitments beyond its WTO commitments in FTAs signed with other countries, it is no surprise that the ECFA contains little in the way of significantly preferential treatments for Taiwanese banks. However, when it comes to negotiating a Cross-straits Services FTA in the future, Taiwan should ask a level of treatment on par with what Hong Kong and Macao get from the CEPA, though it would be very difficult to ask for further liberalization beyond Hong Kong and Macao.

Moreover, it is commonly noted that China's economic interests in the ECFA and subsequent negotiations not only include attracting more capital and talents from Taiwan but also include a desire to make entry into the Taiwan market. For a long time, Chinese investors (including banks) are precluded from investing in Taiwan by Taiwan government's blanket prohibition of mainland investment until June 2009 when President Ma's administration changed the policy and liberalized Chinese investment by a "Positive List" approach. The MOUs of financial supervision cooperation and the ECFA opened the door for Chinese players to set foot in Taiwan.

Major Chinese banks are actively developing their networks in Taiwan. The Bank of China (BOC, 中國銀行) and the Bank of Communications (BoCOM, 交通銀行) recently obtained the approval from Taiwan to open their Taipei Branch,

taking advantage of the ECFA's shorter operation and profit year requirement. The China Merchants Bank (CMB, 中國招商銀行) and China Construction Bank (CCB, 中國建設銀行) also got the go-ahead to set up representative offices in Taipei.⁶⁹⁾

In conclusion, it is undeniable that the ECFA has proven to have immediate positive effects on Taiwan's economy in the aftermath of the global financial crisis. Most of all, China is still a non-market economy despite three decades of reform.⁷⁰⁾ It has a non-transparent, unpredictable nature along with lingering government controls that make it very risky for Taiwan to "put all the eggs into one basket". The ECFA may be a short term solution for coping with the financial crisis, but what Taiwan needs is a global strategy to diversify its economic and trade relations and hence secure more balanced and sustainable economic development.

Taiwanese bankers hope the agreement might secure them preferential treatment in China exceeding the standard terms of access other foreign invested banks are permitted, such as permission to start taking local currency deposits earlier than the standard three-year waiting period (two with profitability deposit not being able to take deposits), permission to exceed a 20% cap on foreign bank ownership, and relaxation of the requirements to hold US\$20 billion in capital assets. The case may be made that waiving the three-year period is not really preferential, since these banks have been waiting for approval for many years.

This paper is written by KIEP support, which the author highly appreciates.

69) Press Release, FSC, Feb. 16th, 2012.

70) China's economy is still highly government controlled, and therefore many countries, including the US, Europe and India, refuse to grant it Market Economy Status.

References

- Asian Development Bank. 2011. *Asian Development Outlook 2011 Highlights*. Philippines: ADB.
- Akyuz, Yilmaz. 2011. *The Global Economy Crisis and Trade and Growth Prospects in East Asia*. Philippines: Asian Development Bank.
- Bergsten, C. Fred, Freeman. Charles, Lardy. Nicholas R. and Mitchell Derek. 2008. *China's Rise, Challenges and Opportunities*. Washington D.C.: CSIS.
- Board of Foreign Trade (BOFT), Ministry of Economic Affairs, Taiwan. 2010. *Challenge vs Opportunity -- Tasks and Prospects in Signing ECFA*. Taipei: MOEA, Taiwan.
- Bower, Ernest. Freeman, Charles. 2010. "Singapore's Tightrope Walk on Taiwan." *Newsletter of Southeast Asian Program*, Vol. 1, Issue. No. 26. <http://csis.org/files/publication/100817-seasia-newsletter.pdf>.
- Chan, Mignonne Man-jung. 2010. *Implications of ECFA on Taiwan, Cross-Straits Development and Regional Integration*. Taipei: Prospect Foundation.
- Chung Hua Institution for Economic Research (CIER). 2009. *The Feasibility Study of the Signing of the ECFA between Taiwan and China*. Taipei: CIER Publishing.
- Chung Hua Institution for Economic Research (CIER). 2011. *Review of Taiwan's WTO Membership for Its First Ten Years*. Taipei: CIER Publishing.
- He, Liping. 2004. "Foreign Banks in China: What Impact Would They Bring About?" *China & World Economy*, Vol. 12, Issue. No. 1. Shanghai.
- Herd, Richard. Pigott, Charles. 2010. "China's Financial Sector Reforms." Economic Department Working Papers No.747. Paris: OECD.
- Hsieh, Pasha L. 2011. "The China-Taiwan ECFA, Geopolitical Dimensions and WTO Law." *Journal of International Economic Law*, 14, 1: 121-156.
- Hsu, Kristy. 2008. "The Role of Taiwan in Eastern Asian Economic Integration." Paper presented at the 2008 ASEAN ISIS-IIR TAIWAN TALKS, September 6-7, in Cebu, the Philippines.

- Hsu, Kristy. 2010. "The Taiwan-ASEAN Partnership: Looking Ahead." Paper presented at the International Conference on Taiwan-China Economic Framework Agreement (ECFA): Building a New Partnership for the Southeast Asian Economic Integration, August 26, in Taipei, Taiwan.
- Liu, Ping. 2011. "The Current State of the Financial Sector and the Regulatory Framework in Asian Economies - The case of the People's Republic of China." ADBI Working Paper Series. Manila: ADB.
- Ministry of Economic Affairs (MOEA), Taiwan. 2010. *Monthly Trade Report*. Taipei: MOEA Publishing.
- Ministry of Economic Affairs (MOEA), Taiwan. 2010. *ECFA's Win-Win-Win: Taiwan, Mainland China and Global Trading Partners*. Taipei: MOEA Publishing.
- PWC. 2011. *Foreign Banks in China*.
- Rosen, Daniel. Wang, Zhi. 2011. *The Implications of Taiwan-China Economic Liberalization*. Peterson Institute for International Economics. Washington D.C.: PIIE Publishing.
- Shen, Chung-Hua. 2010. "Taiwan's Response to the Financial Tsunami." *Managing Economic Crisis in East Asia*, ed. Saw Swee-Hock and John Wong. Singapore: ISEAS Publishing.
- Stephanou, Constantinos. 2009. "Including Financial Services in Preferential Trade Agreements - Lessons of International Experience for China." Policy Research Working Paper, World Bank.
- Tran, Quang Minh. 2010. "Towards an FTA between Taiwan and ASEAN: Opportunities and Approaches." Paper presented at the International Conference on Taiwan-China Economic Framework Agreement (ECFA): Building a New Partnership for the Southeast Asian Economic Integration, August 26, in Taipei, Taiwan.
- Tu, Chaw-Hsia. 2010. "Cross-Straits Economic Relations after the Signing of the ECFA." Paper presented at the International Conference on Taiwan-China Economic Framework Agreement (ECFA): Building a New Partnership for

- the Southeast Asian Economic Integration, August 26, in Taipei, Taiwan.
- Tung, Chen-yuan. 2000. "Taiwan's Investment in China in the Age of Globalization--An Interim Assessment of the Impact of Taiwan's Investment in China on Taiwan's Economic Development." Paper presented at the International Conference on Greater China and the World Economy sponsored by the Chinese Economic Society, July 5-7, in Pudong, China.
- Whalley, John. 2003. "Liberalization in China's Key Service Sectors Following WTO Accession: Some Scenarios and issues of Measurement." Working Paper 10143, NBER.
- Zhao, Hong. 2009. "ECFA and Its Implications for Regional Integration." Paper presented at the International Conference on Enhancing Taiwan-China Cooperation and Strategy in the Aftermath of the Global Financial Crisis, December 16, in Taipei, Taiwan



2

Accession to the WTO: The Case of Azerbaijan

Aynura ISMAYILOVA¹⁾

I. General Review

A. Integration into international trade

It is well known that, international trade system is characterized by varied ongoing processes, but subject to changes on a near-daily basis. The main impact of these changes for states concern their economies. All countries with their unique sets of economical interests is going to find it very difficult to manage their interests

1) **Aynura ISMAYILOVA** is the Head of the Department of Coordination and Training at the Institute for Scientific Research on Economic Reforms for the Ministry of Economic Development of the Republic of Azerbaijan. She has worked for the Institute since from 2009. Her fields of research and teaching areas of interest are data analysis, research methodology, information technology management, and business-training. Her recent research includes preparation of PhD thesis, and studying public opinion, and SPSS analysis. She received her B.A. degree in Mathematics and Information Technologies from Baku State University (Azerbaijan), her M.Sc. degree in Mathematical Modeling from Baku State University (Azerbaijan), and she graduated Master in International Public Affairs from School of Government, LUISS “Guido Carli” University (Italy).
Ms. Ismayilova’s email address: a-ismayilova@hotmail.com

under such an umbrella system. Given the above, we need to come up with a model for the ongoing world-wide economic process and to evaluate its impact on Azerbaijan and vice versa.

Azerbaijan is one of the republics that of the former Soviet Union. There are 6 former Soviet republics that are on the way to WTO membership; *Republic of Azerbaijan, Republic of Belarus, Republic of Kazakhstan, Republic of Tajikistan, Turkmenistan, and Republic of Uzbekistan.*

Having a “helicopter review” to the establishment of the World Trade Organization; which was established in 1995, is the historical successor to the General Agreement on Tariffs and Trade (GATT) which was signed in 1947, and decision makes on the basis of this Agreement and in the years 1986-1994 the Uruguay Round. The main goal of WTO is the liberalization of international trade and regulation of trade-political relations between the Member States, in addition to establish the basis of a treaty in order to allow member states unlimited access to free-trade and world-wide markets for selling goods and services; and regulate conflicts for sale between member states immediately after World War II. In short, WTO is responsible for the development and establishment of new trade agreements, and observation of the member states for the organization all obligations, and ratification by the member states’ parliaments; along with discussions and decisions made on the basis of multilateral trade negotiations (rounds). 8 rounds of negotiations including Uruguay Round have been held to date.

Headquartered in Geneva, Switzerland, as of August 2012, the WTO consists of 157 member countries (23 at the beginning) that represent 95% of the world trade.

B. WTO: main goals, areas and principles

As mentioned above that, the main goal of WTO is the establishment of a free-trade area encompassing the entire globe. With respect to this goal, there are three main areas for the WTO regarding trade and investment:

- *protection of intellectual property;*
- *general agreement on trade in services;*
- *protection of investments.*

WTO's main principles:

- *equal rights:* i.e. all WTO members are obliged to allow to all other member states “most-favored” trading privileges;
- *reciprocity:* i.e. all the concessions in reducing bilateral trade restrictions must be mutual;
- *transparency:* i.e. WTO members should fully publish its trade rules and provide related information to other members of the WTO.

Besides, WTO has achieved increased acceptance of custom rates of 2% or lower; additional income accrued to the world economy due to WTO activities is about 260 billion US dollars, but there are several problems currently facing the organization.

C. International trade of goods and services, and liberalization of foreign trade

As it is known that, without international trade it is impossible to imagine any country, international exchange of goods and services within this international trade relations system. It accounts for about 80% of the total of the world market.

Through the long history of international trade relations history between countries, depending on this nature of the historical criterias, trade has adapted to assume such conditions as:

- the flow of goods import, export, and transit;
- specialization of goods on the nature of raw materials, agricultural products, machinery, equipment, information-technology, and services;
- free trade with government regulation, and trade with government intervention (guardianship);
- nature of payment (cash payment, clearing and barter transactions);
- an ordinary (due to contracts), border, and free economic zones in accordance with geographical localization.

International trade is still affected by many factors, such as i) development level of the international labor market; ii) internationalization of production process; iii) transnational corporations, iv) development of scientific-technical progress, and other.

Trade liberalization is a process reduction or elimination of restrictions on foreign trade. By other words, "...it may include (i) the reduction or elimination of tariffs, (ii) cancellation or increase of import quotas, (iii) the abolition of multiple exchange rates, (iv) eliminating or at least simplifying the process of applying the requirements for obtaining administrative permits for import or placement of foreign currency. The main argument in favor of trade liberalization is that the economy needs international competition to enhance its effectiveness. It is also assumed that the complicated administrative control over trade promotes more development of corruption in government and in the private sector - the desire to receive rental income (rent-seeking), than increase production efficiency ..."

Liberalization of trade is carried out in a similar manner in several countries. For example, it is almost the same for Azerbaijan, Ukraine and Russia, seeming as though they have repeated each other.

II. Historical Review of the Economics for the Last 20 Years: from 1991 to 2012

Within 20 years of independence, the Republic of Azerbaijan has managed to establish sustainable development, a constitution, a national currency, and other attributes of stable government. This actually constitutes a second independence for Azerbaijan, regaining of the main, initial independence achieved in 1918.

Starting in 1991, the Republic of Azerbaijan faced great economic and political difficulties after its second independence. Production of GDP decreased on average by 5.7 percent in 1989-1991. Production of industrial and agricultural products was 2 times less in 1993 than in 1990.

Thereafter, economic reforms were carried out since 1994: implementing the new economic policy, coordinating the tax and bank system changed economy, and achieving rapid growth in the *Gross Domestic Product* ²⁾. Other most important event in 1994, was the signing of the *Century's Contract*, as well as adopting oil as the main national resource and main economic sector of the country. After then *Baku-Tbilisi-Jeyhan Oil Pipeline* (named after H.Aliyev) along with the *Baku-Tbilisi-Erzurum-South Caucasus Gas Pipeline* went into operation, this way country became an exporter of gas as well as oil.

Over the last 20 years, 413.0 million tons of crude oil including gas condensate and 191.6 million cubic meters of natural gas was extracted. 17.8 million tons of motor gasoline, 44.5 million tons of diesel fuel, and 13.8 million tons of kerosene were produced in the same period.

Production in the non-oil sector during the last 10 years, i.e. from 2000 until 2010 increased as well, by an average of 6.2 percent averagely per year.

In general, during the first 5 years of independence, serious crisis led to industrial production decreased by an average of 19 percent within 1991-1996; after then the industrial production increased on average by 10.6 percent. Overall,

2) General indicator of economic development

the country's industries developed rapidly during last 10 years. In comparison, the volume of industrial production in 2010 alone was equal to the volume of production produced throughout the 1950s and 1960s; the volume of production during last 5 years was equal to volume of production from 1950 to 1970.

One of the main tasks of the country is economic development of its constituent regions. Regions with different potentials can provide numerous advantages. In Azerbaijan's case, this is important with respect to development of the non-oil sector development, especially manufacturing. Examples include electric power stations in regions such as Sumgayit, Guba, Sheki, Astara, Khachmaz; a truck crane named as "Kapaz"; an automobile plant producing a type of "Belarus" and a Maz-type tonnage lorries; sugar-mills in Imishly; an automobile plant producing "Lifan" motor cars in Nakhchivan; and there are still other business and facilities like bakeries, salt plant, dairy, brewery, butter, ice-cream plant, furniture plant, canning factory, brick factory, brewery, and juice producing plant created.

Opportunities and potential of above industries prompted the establishment of the *Azerbaijan Investment JSC* by the Decree of the President of the Republic of Azerbaijan, on 30 March 2006.

Azerbaijan has also worked hard to improve its international relations and standing. Starting from 1993 the country has established functioning embassies and consulates with representatives in 66 countries around the world. Diplomatic missions of 56 countries are in Azerbaijan. Azerbaijan ranked 67th amongst 169 countries in the UN report on Human Development. Presenting favorable conditions for both internal and external investor investment increased, as well. More than three fourth of the investment funds in 2010 were from fixed capital and constituted domestic investment, 24.3 percent investment came from foreign sources. 73.9 percent of funds from internal sources were shares possessed by public/state enterprises and organizations, and 26.1percent by non-state enterprises. Foreign investment flow to the independent Azerbaijan being increased each year, peaking in 2010 with investment amounting to 8.2 million US dollars invested during this year. Foreign investment totaling 54.4 million US dollars were

earmarked for development of the country's economy from 1994 to 2010. 68.9 percent of investment were introduced to the economy as direct investment and at the same time US\$33.1 million or 60.9 per cent – went toward development of the oil industry. For the last 20 years the amount of direct investment invested by foreign and joint companies to the non-oil sector of the economy during last years has increased each year and the volume of direct foreign investment in non-oil sectors at the end of 2010 amounted to US\$4.3 million.

As a result of agrarian reforms, 2239 collective/state farms and several agricultural enterprises were closed. 1525 agricultural enterprises, including 219 state agricultural enterprises, 331 collective (joint) enterprises as well as 73 agricultural production cooperatives (LTD, JSC and etc.) and 902 agricultural enterprises had been established by the end of 2010. There were 41 agro-service enterprises, 437 irrigation companies, and 33 service enterprises for plant cultivation and livestock.

The “Silk road” transport corridor, transnational project (between Europe-Caucasus-Asia) in operation since 1998, was realized during the restoration following the 1991 independence.

One of the important areas in economic development is Information Communication Technologies, i.e. ICT services, involving widespread use of the internet, mobile phones, and others. Mobile phones have been in use since 1994; there were 164 radio-television stations in 1993, have increased 1.9 times by 2010. Also, by 2010, there were 599,600 computers, being used by 3.4 million persons. The number of internet users made 3.259 million persons which represents a figure of 36 internet users per 100 persons. One of a four enterprises functioning in the country have computers with 161.6 thousand employees in these enterprises using a computer; 70.9 thousand employees – use the internet.

The volume of trade turnover with foreign countries in 1993 was 1353.5 million US dollars, in 2010 this figure reached to 27.9 million US dollars, which increased by 20.6 times compared to 1993. There were changes in the structure of foreign trade relations during these years. The share of food products imported

to the country in total volume of import which was 21.2 percent in 1993 and 41.6 percent in 1995, respectively, decreased by 18.6 per cent in 2010. The enterprises registered in state statistical register mainly come from the following countries: *Turkey, Great Britain, Russia, Iran, USA, and Germany.*

At the beginning of 2010-2011 academic year, 1.325 million persons were being educated in 4515 state and 17 non-state educational institutions. 51 higher and 62 secondary specialized educational institutions were in operation during the period mentioned. Financing of education from the State Budget increased year by year, from 37.1 million manats in 1991 to 1181.4 million manats in 2010. Additionally, in October, 2010, there was one average level 1 computer per 33 pupils; 1760 schools (47 per cent from total) were connected to the internet, or 84 percent at the moment. 2055 Azeri students are being educated in abroad, with the number of foreign students being educated in Azerbaijan also increasing.

At the beginning of 2011, 141 research organizations and institutions engaged in a diverse array of scientific and technical activities were in operation, with approximately, 18000 specialists (62 percent of all researchers) involved in research and development activities. At the beginning of the 2011, there were 57 academics, and 109 correspondent members.

By the decree of the President of the Republic of Azerbaijan in 2008, public libraries with a total stock of 36 million books, along with 2750 clubs, 226 museums, 28 professional theatres, 4 philharmonic orchestras, 6 musical collectives, 2 concert halls, and 365 cultural and recreational parks were made to provide service to the Azeri citizenry. An important cultural monument, the National Historical-Cultural Reserve of Gobustan was included in the UNESCO List of World Heritages. At the beginning of 201, there were a number of sport facilities completed, in addition to an extensive health infrastructure including 516 hospitals, 1688 outpatient clinics, 72 ambulances, 472 antenatal clinics, children's outpatient clinics and ambulatories, 75 sanatorium-rest homes staffed by 33000 physicians, and 60000 paramedical personnel. New hospitals, diagnosis centers, with modern medical equipments were built and went into operation in different

regions of the country during last 20 years.

As of January 1, 2011 there were 1.292 million registered pensioners, with average fixed monthly pension expenditure of 112.9 manats per person and representing 34.7 percent of average monthly wage. There were 297.2 thousand persons receiving fixed monthly social benefits and 101.1 thousand persons receiving lump sum allowance from the state as of 1 January of the current year, according to data from the Ministry of Labor and Social Protection of Population. These benefits were granted for childbirth, treatment of disabilities as a result of radiation accident, funeral benefits and persons from prisons.

III. Azerbaijan is on the Way to WTO Membership: from 1997 until 2012

A. In brief

As we noted above, WTO accession for the country wanting to be a WTO member, is a long-term, complex process consisting of a number of important steps. In practice, the WTO accession process lasts anywhere from 2 to 15 years, depending on the strategic approach, the level of development and economic interests of the counties.

The process WTO accession can be divided into 4 stages: *(1) preparation of the Memorandum of Foreign Trade Regime; (2) questionnaire stage with questions and interests of the WTO member States; (3) negotiations stage; (4) WTO approval of membership, and the beginning of the internal process.*

B. Application for Membership and Memorandum of Foreign Trade Regime

On 23 June 23, 1997, Azerbaijan's official request (i.e. application), containing

its express wish to become a member of WTO, was submitted to the WTO Secretariat. On *16 July, 1997*, the *First Working Group* was established at the WTO Secretariat on behalf of the Republic of Azerbaijan. The Chairman for the Working Group on WTO accession was Walter Lewalter, and its members included representatives from the USA, European Union, Australia, China, Dominican Republic, Kyrgyzstan, Georgia, India, Honduras, Croatia, Switzerland, Jordan, Japan, Canada, Republic of Korea, Egypt, Malaysia, Moldova, Norway, Oman, Pakistan, Panama, Paraguay, Sri Lanka, Taiwan, Thailand, Turkey, Vietnamese, Brazil, Ecuador, Switzerland and Ukraine.

As a rule, WTO accession for big countries, such as Russia and Japan, a large number of countries are included in the Working Group, but for the small countries the Working Group established by the 4 countries (Canada, European Union, Japan and USA) and neighbouring countries. In general, this stage lasts several months.

On *22 April, 1999*, after almost 2 years, Memorandum for Foreign Trade Regime of the Republic of Azerbaijan was submitted to the WTO Secretariat. The Memorandum is a document whose preparation can be very complicated for the applicant country, and contains several major issues, such as trade goods and services, mainly based on issues of service trade on financial sector; security sector; professional-consulting services; communication services and so on. All above-mentioned sectors are significant issues in and of themselves. If the applicant country has not analyzed them thoroughly for the preparation of the Memorandum, the next stages can be come very drawn out.

On *19 November, 1999*, Order #226s of the Cabinet of Ministers for the Republic of Azerbaijan was issued to speed up the work of the Coordination Group for strengthening inter-departmental cooperation.

C. Azerbaijan's local preparation Commission to the WTO accession

On 23 August, 2003, in order to speed up the process outlined in the Order #175s of the Cabinet of Ministers for the Republic of Azerbaijan which established the Commission, the secretariat for the Commission was established at the Ministry of Economic Development.

On 07 July, 2009, the members of the Commission were approved by the Order #160s of the Cabinet of Ministers for the Republic of Azerbaijan.

The Chairman for *the Commission* would be the minister of economic development, Mr.Shahin Mustafayev; the deputy chairmen's positions were occupied by the deputy minister of foreign affairs, Mr.M.Mammad-Quliyev, and deputy ministry for Justice Mr.Togrul Musayev. The members of the Commission were drawn from different government bodies. The aim of the Commission in connection with all related agencies is the discussion of the proposals, unique economic policy of the country and documents to the WTO.

D. Meetings of the local preparation Commission

The first meeting, 07 October 2003

Decisions made were as follows:

- establishment of Working Groups on 9 different directions;
- preparation of the Action Plan on the WTO accession;
- preparation of plans for the meeting of the Working Groups.

The second meeting, 21 June 2004

Documents approved were as follows:

- Schedule for WTO accession on Agricultural-Domestic Support and Export subsidies;
- Schedule for WTO accession on Sanitary-Phytosanitary measures and on Trade Technical Barriers;
- Schedule for application of the WTO Agreement on Intellectual Property

Rights on trade issues;

- Answers to the submitted questions;
- translation into English the Custom Import Fees of the Republic of Azerbaijan;

The third meeting, 22 February 2005

Decision made to expedite preparation and submission of the relevant documents to the WTO Secretariat;

The fourth meeting, 22 April 2005

The approved documents:

- the highest degrees for Customs Import Fees (Bound Tariffs);
- Schedule for WTO accession for Services;
- Schedule for WTO accession for Service Offers (Services Offers);
- Schedule for WTO accession on Agricultural Domestic Support and Schedule;

The fifth meeting, 03 February 2006

The documents approved:

- collection of the Answers of the Questions;
- Legislative Action Plan;
- updating of the table for the WTO Agricultural Domestic Support and Export, and answers;
- updating of the highest level for Custom Import Fees (Bound Tariffs);
- updated version of the Service Offers;

The sixth meeting, 26 May 2006

Topics for discussion:

- submission of report on visit to Geneva;
- submission of the report from the Working Groups;
- defining tasks for the Working Groups for the next period;
- adoption of the Work Plan for the next period;

The seventh meeting, 27 February 2007

Topics for discussion:

- preparation for the next 5th session of the Working Group;
- technical and financial support for the WTO accession;
- evaluation of the situation related to the adapting the National Legislative system to the WTO;
- discussion of the import fees for goods in agriculture and industry;

The eighth meeting, 06 June 2007

Topics for discussion:

- signing of bilateral agreements, speeding up bilateral and multilateral negotiations;
- preparatory proposals for changes in laws on Normative Legal Acts;
- evaluation of the situation from changes in Normative Legal Acts for the Import Fees for the products;
- analyzing current situation related to liberalization;
- adoption of several changes in Laws fees, monetary policy, patents, producing products in Azerbaijan;
- adoption of other related Law related to WTO Sanitary measures

The ninth meeting, 23 November 2007

Agenda: custom tariffs; country's entry status; sectoral initiatives and subsidies on agriculture with access were discussed.

The tenth meeting, 04 July 2008

Several additional aspects related to the WTO accession were discussed during the meeting.

The eleventh meeting, 05 February 2010

Structure of the Working Group changed; evaluated the situation of the bilateral and multilateral negotiations; reviewed tariff regulations and several other issues.

E. Multilateral negotiations

As mentioned above, the Working Group on WTO accession was established on 16 July 1997, with organized, regular sessions held starting in 2002, as well as, its first meeting in Geneva.

The Working Group's last and 9th session was held on 24 February 2012. The 9th session of the Working Group was held on 24th of February, 2012. For this session several documents including justification on "developing country status", status of legislation reforms (copies of the documents have been presented to the WTO secretariat) as well as revised offers in goods and services were prepared and submitted to the WTO Secretariat. After the session, there were questions received from EU, US, Saudi Arabia and Taiwan.

Two sessions (7th and 8th) of the Working Group were held in 2008. The 5th and 6th sessions of the Working Group were held in Geneva on 11 December 2008, and on 06 May 2008, respectively.

The related documents, such as: *a) completed offers for goods and services; b) drafts of about 30 legislative acts; c) ad valorem equivalent of specific duties and etc.* were submitted.

Official questions covering different issues, such as, sanitary and phytosanitary measures, technical barriers, intellectual property rights, import licensing have been answered and submitted to the WTO Secretariat after negotiations.

F. Bilateral negotiations

Bilateral negotiations proceeded in parallel with multilateral negotiations. Bilateral negotiations were held with the USA, EC, Canada, Japan, Brazil, South Korea, Ecuador, Sri Lanka, India, Norway, Switzerland and Taiwan in the context of Azerbaijan's accession to the WTO. Questions from these countries were mainly about service and good market discussed within the negotiations. Following the negotiations, 5 bilateral agreements signed. First of the agreements was signed

with Turkey in 2007, followed by Oman in 2008, UAE in 2008, Georgia in 2010 and Kyrgyzstan in 2012.

The next following round of bilateral negotiations on Azerbaijan's accession to the WTO conducted on 20-24th of February of the current year, and as a result had bilaterals with few countries, including the US, EU, Canada, Ecuador, Norway, Japan on goods and services. On 20th April, bilateral negotiations were held with the US in Washington.

G. Adaptation of the Legislative System to the requirements of WTO

The Action Plan, contained and put into motion by Decree #1583 on 02 August 2006, at the behest of the President of the Republic of Azerbaijan, initially envisioned providing a total of 37 juridical-legal documents, but only 17 of them were adopted and entered into force including: 9 laws, 1 Decision of the Cabinet of Ministers, and 7 Presidential Decrees.

J. Public awareness

Taking into account the importance of public awareness, the public web site www.wto.az (in Azeri) was launched. All information related to Azerbaijan's WTO accession was shared with public through web site.

In addition, the State Committee for Standardization, Metrology and Patents for the Republic of Azerbaijan established a Public Survey Center. US Agency for International Development (USAID), within the framework of Trade and Investment Reform Support Program, and also within the jointed project "Support to the Government of Azerbaijan in Trade and Investment Reforms" organized seminars for the entrepreneurs in the regions.

A number of other seminars related to WTO accession, including practice of the member countries, were organized for the officials.

IV. Azerbaijan's WTO Membership Wish: Expectations for Future

The Republic of Azerbaijan officially applied to the WTO Secretariat with the intention of becoming a WTO member in 1997; but unfortunately, actions of the Azerbaijani government for the last 15 years shows that is the government's intentions were not genuine. In addition, negotiations both bilateral and multilateral did not lead to expected outcomes. In general, approaches to WTO membership concerns tariffs regulation, and more specifically, increasing of the tariffs. This has become a main obstacle, but but the expectation is to evaluate tariff regulations, after which negotiations related to the tariffs can begin.

Walter Lewalter's conclusion related to Azerbaijan's WTO accession for the Business Year was optimistic: *"... each accession strengthens the rules and disciplines of the trading system. Vanuatu, a small archipelago in the South Pacific, is on the verge of becoming the 154th WTO Member. WTO Members are engaged and ready to work with Azerbaijan. They follow developments closely and look forward to welcoming Azerbaijan in the not too distant future. Let's roll-up our sleeves and work! ..."*

For WTO membership Azerbaijan should pay special attention to progress in the following areas: (a) changes in the legislative system; (b) decreasing import-custom tariffs; (c) refrain from subsidies for national producers.

As mentioned, WTO membership is a long-term process; all related decisions should be made on the basis of broad-ranging, extensive research; country should prepare itself fully to the process before applying to the WTO.

References

- Bayramov V. *Azerbaijan's Accession to World Trade Organization (WTO)*. Baku, Azerbaijan, www.cesd.az, www.aamik.az. (July)
- Rahmanova, A. 2001. *Accession to the WTO: the case of Kyrgyzstan*. Bishkek, Kyrgyzstan. (July)
- Jonathan, M. 2003. *the Handbook of Globalization*. USA.
- Aliyev, A. *Analysis of application and perspectives of development of electronic commerce system within the framework integration of Azerbaijan to World Trade Organization*. Baku.
- Рахманова А. 2003. *Интеграция Кыргызстана в международное экономическое сообщество*, Бишкек, 180 стр.
- <http://www.thebusinessyear.com/publication/article/3/662/azerbaijan-2011/on-course>
- <http://www.wto.az>
- <http://www.wto.org/english>
- <http://dic.academic.ru/dic.nsf/econ-dict/21321>

Features of the Currency Policy and Exchange Rate of Belarus in the Conditions of Forming the Common Economic Space

Maryna Markusenka¹⁾

1. Introduction

The solution of the exchange rate problem is one of the main goals of the monetary policy related to the international integration conditions of the countries in transition.

The countries in transition have problems connected to the balance of the balance of payments and stability of exchange rates. Therefore the currency policy is allocated from a monetary policy here.

The most difficult policy is that of the exchange rate in the countries of Common economic space (CES). CES was founded on the basis of a customs union of Russia, Kazakhstan and Belarus. This regional economic has been active

¹⁾ Maryna Markysenka is an associate Professor at the Institute of associate professor, The Institute of Economy of the National Academy of Science of Belarus (Republic of Belarus, Minsk)

since January 1, 2012.

Main purposes of the formation of CES are:

- effective functioning of the common internal commodity market, services, capital and labor,
- creation of conditions of stable development and structural reforms,
- implementation of coordinated tax, monetary, currency, financial, trading, and customs policy,
- creation of the common system of state support for priority branches of economy and enterprises.

It is possible to expect that creation of the CES will lead to achievement of following results:

- improved business environment in the common markets of participating countries,
- possibilities for growth of investments,
- lower risks for business deals because of international legal guarantees.

Agreement on a coherent macroeconomic and currency policy involves the formation of common principles for the functioning of economies of participating countries of CES, which would lead to fundamental changes in the economic model of the Republic of Belarus.

Thus, the first step in integration should be the coordination of the economic development indices and in particular monetary ones; the common directions for exchange rates and monetary policy regulations are being developed and coordinated.

II. The Currency Exchange Rate Adjustment in the Republic of Belarus

2.1. The currency exchange regime selection

The currency exchange rate adjustment includes the currency exchange regime selection and its supporting measures.

Pursuant to IMF classification, the member countries of IMF use ten main variants of exchange rate regimes with varying of fixity and flexibility. The main exchange rate regimes used are flexible fixation (78 countries) and float (75 countries). Moreover, the regimes of strict fixation are also used (23 countries) and other rate control regimes (12 countries) [1].

The flexible fixation regime has three variants:

1) the ordinary flexible fixation (in a period determined to be no less than 6 months during which the rate ranges from 1 to 2% regarding the officially declared rate of the other currency or currency basket);

2) the real stabilization (in no less than 6 months, the rate ranges within 2% of interval that is under control of monetary authorities who doesn't declare it as a target level);

3) the transitional forms of fixation: the horizontal range (more than 1%); crawling peg (flexible fixation but an interval is set regarding the level of change periodically, for instance, depending on inflation of different macroeconomic indicators, and the rule of exchange rate formation is declared in advance); real crawling peg (an interval is revealed by the rate dynamic for 6 months, the rule of exchange rate formation isn't declared in advance).

Concerning "float" regimes, two main variants can be singled out:

a) managed float (the rate is determined primarily by the market, but the monetary authorities intervene actively in the process of the rate exchange formation making foreign currency interventions);

b) free float (the rate is formed almost solely by the market, with foreign

currency interventions being made episodically).

For instance, according to IMF classification, the policy of managed float is at work in Mexico, Argentina, Indonesia, Turkey, India, Taiwan, Thailand, and South Africa; the free float – in Brazil, Australia, Poland, South Korea; the real stabilization – in China. Russia belongs to a group of countries with other regimes of rate control. In Russia, the carried rate policy is determined as the horizontal range, but the ranges are very wide as to almost allowing for the free float. In addition the Central bank of Russia intervenes actively in exchange rate formation.

One can agree with the view of experts who consider the currency rates regime classification mentioned above as very detailed and slowly updated by the IMF. The given classification is not even updated annually, while in crisis conditions the central banks of several countries take radical decisions rather promptly [1, p. 33].

According to the reckoning, a more enlarged classification is important to an extent, for instance, where it would be very difficult to determine the differences between flexible forms of fixation, especially between the real stabilization and the transitional forms of fixation. Identification of three main types of regimes of currency exchange rate: fixing rate regime, float rate regime, transitional regimes, i.e. adoption of more enlarged classification allows for simplification of the conditions of the exchange rate formation analysis used by the countries.

Experts point out that the transitional regime that includes several variants of both controlled fixing rate and managed float rate is more readily acceptable for the countries with emerging markets. The countries with the transitional regimes are in a better position per indexes of current account deficit of payment balance. According to the indicator of inflation average levels, a number of countries using the transitional regimes are not in a good position – 12.9%, while the countries with the fixed exchange rate have the inflation average of 11.7%, the countries with the float exchange rate – 17.1%. The index of the currency exchange rate volatility is similar for the countries with the transitional and fixed regimes (7%) in annual range whereas, in the countries with the float currency exchange rate

the given index amounts to 12% [2, p. 19]. Therefore, the countries' experience shows that by total factors, the transitional regimes of the currency exchange rate for the countries with the emerging markets stimulate the macroeconomic stability than other currency exchange rate regimes.

2.2. The regimes of exchange rate used in the Republic of Belarus

The binding regime of exchange rate to the Russian ruble was being used in the Republic of Belarus during 2001-2007. The binding regime to the USD was used in 2008. The National bank of the Republic of Belarus moved to the exchange rate binding of the Belarusian ruble to the currency basket (which included in equal parts the US dollar, euro, and the Russian ruble) from 2009. The given regime, as the ones previously used, was a diversity of the flexible fixation regime (the horizontal range). During 2009 the rate of the Belarusian ruble to the currency basket has depreciated at 8% in comparison with the initial level during 2010 – at 1.8%, i.e. for two years it was being kept within the set 10-% range.

The global experience points to the fact that the horizontal foreign currency range is set, as a rule, under conditions of disposable capital deficiency at the finance market because of high internal and foreign debts. Such regime allows more precise prediction of the economic situation and to lowers risks considerably while realizing foreign economic operations. It becomes a sufficient stabilizing factor for the entire national economy. The effectiveness of using the above mentioned regime in Belarus is proved by the fact that during the world finance and economic crisis in 2009-2010, the monetary authorities managed to support the stability in the foreign currency market. In 2009 the cardinal measures had to be taken for the local currency stabilization - in particular, a one-time 20% devaluation that was the basis for maintaining stability in the foreign currency market.

Using the regime of binding to the currency basket in 2009-2010 had the following effects in Belarus:

1) In underdeveloped financial market condition, the requirements of business entities – exporters and importers in financial derivatives, were not met (options, futures). Therefore the usage of the foreign currency exchange rate fixed regime minimized loss among business entities in the real sector of the economy while realizing adequate production and commercial operations.

2) Using the fixed foreign currency exchange rate has increased the investments in the local currency. This tended to stimulate deposits in local currency, reducing the demand for foreign currency.

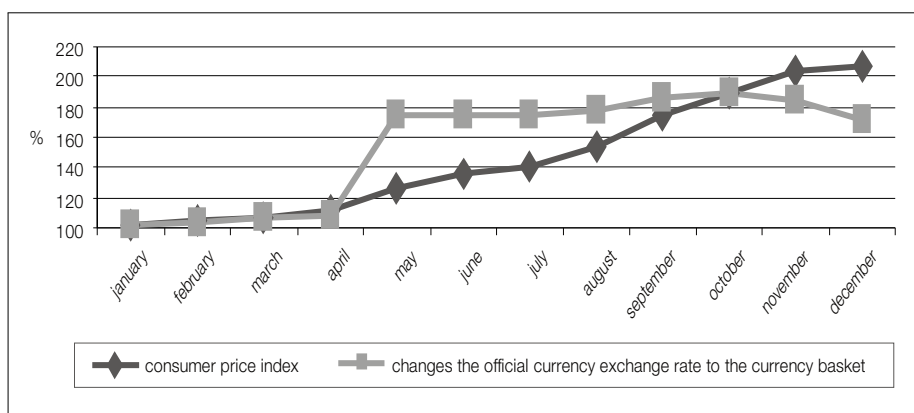
3) At sufficiently high rates of inflation (for 2010 the growth of consumer prices index amounted 109.9%) the state policy of depreciation of both the nominal and real exchange rates stimulated export expansion.

The reviewed features of the used currency exchange rate regime for an extended period time had a positive effect on the economic situation in Belarus.

At the same time, result of the year 2010 was the negative foreign trade balance which reached minus USD 9.6 billion. Therefore the government had to cover the deficiency of foreign currency in the country by means of the attraction of external loans and Eurobonds distribution. At the beginning of 2011 the situation came to a crisis in the foreign currency market as the currency supply into the country could not cover the growing needs, which were also the result of increase of public mistrust of the monetary policy of the state. The National Bank had to extend the foreign exchange limitations in order to maintain the exchange rate, at the price of significant reduction of the volume of international reserve assets. Thus, the procedure of the priorities was established at the stock exchange while fulfilling a request for foreign currency purchases: the highest priorities were set for payment for medicines, for supplies of natural gas to the republic, and for the repayment of loans in foreign currency.

In April-May of 2011 the increased demand for foreign currency purchase from the population was observed. This was due to buying the currency by

Figure 1. The dynamics of consumer price index and changes in the official currency exchange rate to the currency basket in 2011 in the Republic of Belarus



individuals for attaining the cars abroad and difficult technical goods, and devaluation expectations. Considering the situation emerging in the domestic foreign currency market, the National Bank and JSC “Savings Bank Belarusbank” decided to sell the currency for socially important purposes (treatment, payment for study abroad and etc.)

Measures taken by the National Bank were insufficient, which led to a one-time devaluation of the exchange rate in May. As the result, the exchange rate of the Belarusian ruble to the foreign currency basket depreciated by 75% for the period of January-July 2011. Yet even after the devaluation, the currency exchange rate of bidding to the currency basket was still realized, which was a kind of fixed regime.

After devaluation in May 2011 the situation in the foreign market did not stabilize, as the currency supply into the country still did not cover the increasing demand. The excessive demand for foreign currency was expressed by the public mistrust to the monetary policy, and the foreign currency remained unsupplied. From September 14, 2011 the second trade session started at the Belarusian currency and stock exchange, where the exchange rate of the Belarusian ruble

to the main currencies (US dollar, Euro and Russian ruble) was determined on the basis of supply and demand. For the first two weeks, the National Bank did not intervene to influence the exchange rate. The unification of the exchange rate was finally realized on October 20, 2011, the rate amounted 8,680 rubles for one US dollar and the additional session taken by Belarusian currency and stock exchange was discontinued. By the end of 2011 the Belarusian ruble depreciated by 172% relative to the value of the foreign currency basket at the beginning of the year (figure 1).

The National Bank of the Republic of Belarus declared a change in exchange rate formation, i.e. the transition to the managed float exchange rate.

2.3. The transition to the float exchange rate

The concept of the international exchange rate policy worked out mainly by the developed countries and IMF during the last few years focused on the implementation of free float exchange rates of the local currency. The followers of exchange rate formation flexibility confirm that the free float exchange rate will provide more independence for central banks while responding to external factors. However, the world economic crisis of 2008-2009 show that the capital outflow from the country, coupled with speculative attacks on the local currency can cause losses related to its exchange rate changes. The fact is that the free float exchange rate regime is of interest for the most competitive and mainly developed countries – leading exporters of goods, services, capital, whose currency is widely used in international operations. Moreover, their economic benefits turn round losses of states with emerging markets. A necessary condition for the transition to the free float exchange rate regime is the creation of an institutional environment and application of financial instruments for the foreign currency risks hedging. Besides, the important thing is to achieve sufficiently low inflation rates.

The main directions of the monetary policy for 2012 were the changes in the regime of the exchange rate policy of the National Bank, which proposed operations in a managed float exchange rate. The aim of the monetary policy for 2012 was to achieve price stability. The document also stated that a significant slowdown of inflation would create conditions favorable to providing relative stability in the Belarusian ruble exchange rate.

The exchange rate of the Belarusian ruble was determined to be formed with minimal involvement of the National Bank in terms of the supply and demand of foreign currency. At the same time the National Bank assumes the possibility of foreign currency interventions for smoothing drastic fluctuations of the Belarusian ruble exchange rate. Consequently, in 2012 the National Bank changed the exchange rate formation regime and transitioned from the fixed exchanged rate regime (binding of the exchange rate to the currency basket) to the managed float regime.

The specialists indicate the main criteria for transition on the float exchange rate regime as follows:

- the level of market relations development, which would permit allocation resources efficiently and providing of self-leveling of the trade and current account balances;
- the scale and characteristics of the economy (diversification of production and international relations);
- the level of economic stability (low inflation, sustainable economic growth, and balanced macroeconomic proportions) [3, p. 13].

It is obvious that in Belarus there were no major preconditions for the transition from the binding to the currency basket regime to the float exchange rate regime of the local currency. It is specified that in Belarus recorded a negative foreign trade balance in 2011, along with high inflation rates; there was no possibility of massive currency intervention to regulate the foreign exchange market owing to the insufficient levels of gold and currency reserves.

Still the National Bank has decided to change to a managed float regime starting in January 1, 2012. In order to ensure that the regime achieve exchange rate stability, it is essential to increase the effectiveness of the monetary policy by restructuring its mechanisms, reconsider the goals of money-and-credit sphere development, as well as improve the operational procedures management that will raise the level trust regarding the policy implemented. Regulation of exchange rate of the local currency is typical (when necessary) even in those countries where the free float exchange rates are used. There is an opinion among economists that the exchange rate dynamics (in the framework of the float exchange rate regime) assumes a stabilizing function and provides the monetary regulation authorities with a wide range of opportunities in realization of monetary policy [4, p. 13]. In addition, the international experience shows that in spite of declarations on transition to the float exchange rate, many countries continued to intervene in exchange rate formation and sometimes had specific aims with respect to the rate level. Thus, the National Bank interfered with the foreign exchange market activity through intervention during the managed float exchanged rate in cases of imbalanced growth in the economy, excessive volatility of macroeconomic indicators, or threat of misalignments. At the same time, the exchange rate policy should be coherent, i.e. the coordination of exchange market intervention with the main operations of the central bank should be a requirement and they should not become obstacles for achievement of monetary policy goals [5, p. 53].

Policy practices around the world shows the developing economies still remain dependent on extant exchange rate dynamics during the transition to the float exchange rate. The main reasons are:

- firstly, the high level of transition effect, which is defined by the impact of the currency channel of monetary transmission mechanism;
- secondly, the existence of liabilities in foreign currency and insufficient development of financial markets.

The above mentioned factors will influence the exchange rate dynamics in the Republic of Belarus amidst the transition to the float exchange rate regime.

With the view of supporting and achieving a particular exchange rate level, the central bank should monitor the dynamics of real exchange rate. One of the main indicators for analysis of the effectiveness of the exchange rate regime is an index of changes in the real exchange rate – an index of nominal exchange rate changes adjusted at inflation indicator.

The calculation of the real exchange rate allows the comparison of the relative purchasing capacity of the local currency within the currency dynamics. The dynamics of the real exchange rate influence exports and imports, and the trade balance, respectively. Strengthening of the real exchange rate against the background of high inflation causes the loss of price competitiveness of domestic producers output; devaluation, on the other hand, causes its improvement.

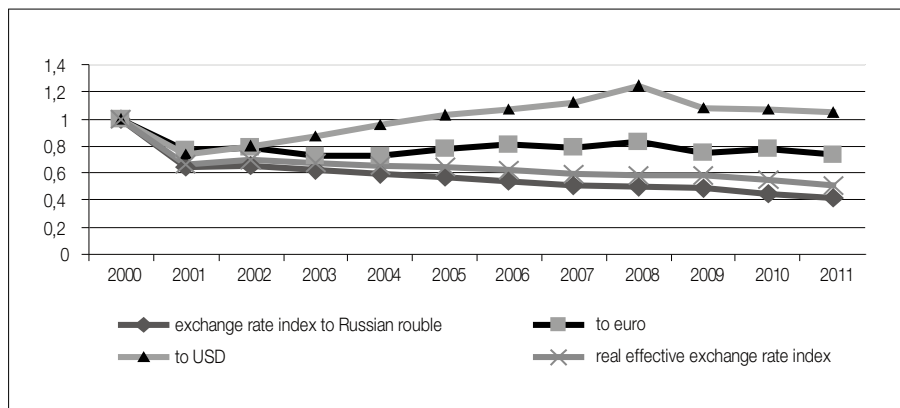
In addition, the indicator of real effective exchange rate, determined as the result of weighing the real exchange rates of other countries, meaning its main trade partners, is applied for the above mentioned analyses.

According to the IMF's definition, a real effective exchange rate of the local currency means an estimated nominal effective exchange rate including dynamics of the national and international indicators of prices or costs; - the nominal exchange rate of the local currency, weighted to the currencies of the countries – namely the main trade partners of the issuer. A similar definition is given in the local literature: "The real effective exchange rate – the nominal effective exchange rate adjusted for variation in the price levels and other indicators of production costs showing the dynamics of the real exchange rate of the given country to the currencies of countries – main trade partners" [6].

Pursuant to the foreign exchange theory, the indicators of the dynamics of the external costs of currency constitute the indexes of effective exchange rate. These indexes are calculated, including the structure of national (regional) foreign trade [7, p. 58].

The central banks use the index of effective exchange rate as an integrated indicator of the local currency dynamics. The central banks interpret in different ways the given index; it plays a role in comparative assessment price

Figure 2. The dynamics of the real exchange rate indexes of Belarusian ruble to the currencies of the countries - major trade partners (calculated by the consumer price index) in 2000-2011.

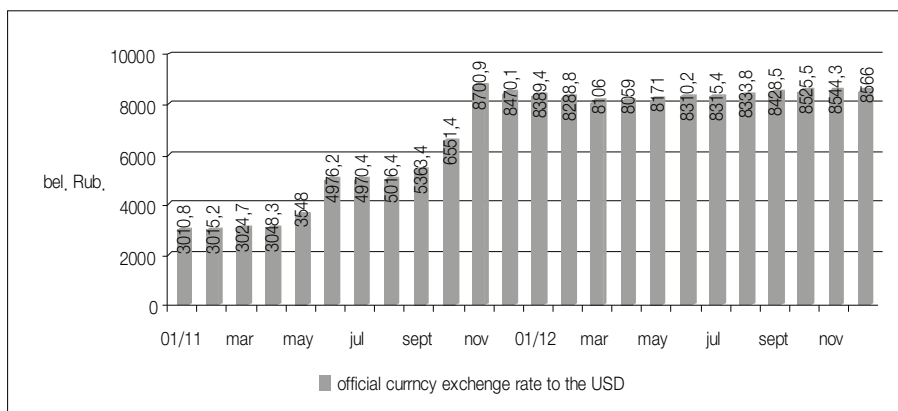


competitiveness of products, and also as an instrument of direction determining change of the external local currency value. The formation order, interpretation and use of the effective currency rate index by the central banks and international organizations forms the basis for the conclusion that the present figure is considered an indicator of changes in currency external cost. The consequences of changes in currency cost can affect primarily the country position in the foreign trade sphere and so is interpreted as an improvement or deterioration in the international price competitiveness of the national output.

The real effective exchange rate index tended to decrease in the Republic of Belarus in 2000-2011 (Figure 2). In 2010 the present index decreased by 6.6% to the level of 2009. Moreover, due to the fact that Russia represents about 50% of international trade transactions of Belarus, the real exchange rate index to the Russian ruble has similar dynamics.

The devaluation in 2011 caused a domestic demand reduction for goods and services of domestic producers, as the devaluation of the local currency led to price increase in the Belarusian ruble for their production. At the same time the

Figure 3. The dynamics of the average official currency exchange rate to the USD in 2011-2012 in Belarus



prices for import goods (enumerated in the local currency) rose more slowly. Meanwhile, the devaluation helped maintain the demand for Belarusian products at the foreign markets. In 2012 the real effective exchange rate decreased also.

In 2012 stability in the currency market was maintained (Figure 3). But the interbank currency market has not yet gone into operation. There are a number of restrictions with respect to operations of the current account.

As for future prospects, the real effective exchange rate should be depreciated in order not to reduce the competitiveness of Belarusian producers and to increase the export effectiveness.

III. Scientific Base of Methods and Instruments of Monetary Policy in the Common Economic Space (CES) Conditions

3.1. The history of the question.

The first steps to monetary and financial policy coordination were made by

the CIS countries in the early 90^s, which culminated in the establishment of the CIS Interstate bank in 1993. The Agreement on the Payment Union was concluded in 1994. The Union state of Russia and Belarus was founded in 1998, where the project on transition for a common supranational currency was developed. The development of integrated CIS currency market project was started in 2011. Due to several reasons the progress in the field of monetary integration was very slow. The results of integration were quite low.

Today, Belarus, Russia and Kazakhstan are at the stage of internal convertibility of local currencies. At present the exchange rate of these countries is formed in the domestic foreign exchange market based on supply and demand, and the official exchange rate is determined by the market exchange rate. An organized market for exchanging currency is the base of the foreign exchange market in the given countries. The interbank foreign exchange market is being developed. Under current conditions in Russia, Belarus and Kazakhstan, the interest has grown significantly toward the monetary and financial cooperation. The crisis of 2008-2009 has demonstrated once again the high level of mutual dependence of the countries. The size of industrial and agricultural production, transportation and retail turnover began to increase during post-crisis era conditions (in 2010-2011) in Russia, Belarus and Kazakhstan. What is more, in partner countries like Belarus, we can observe maintenance of relatively stable exchange rates of local currencies against the U.S. dollar, increasing the nominal income of population, and deceleration of inflation rates.

The CES countries should take into account the international experience during the integration, and also the experience of CIS and common state of Russian and Belarus. These countries should determine their way of cooperation in monetary and financial sphere. Moreover, it is necessary to develop the model of a common monetary area in the long term.

3.2. Theoretical approaches, conditions for the foundation of monetary areas

The theory of optimum currency area is at the heart of the modern foundation processes of currency areas. The theory was created by the famous economist and Nobel laureate Robert Mundell. In 1961 he theorized the possibility of a country group eschewing their local currencies in favor of a common currency. This theory was the basis of the established European Economic and Monetary Union in 1999. Mundell's proposals were based on the ideas of John Stuart Mill, the famous economist of the 19th century, who described as barbarity fixation on one's own currency [8, p. 24].

In 1950 the agreement on the European payment union was concluded in Europe, and in 1957 the Treaty of Rome on European Economic Community establishing (European Common Market) was signed. The Treaty of Maastricht concluded in 1991 marks the starting point of the European Union. The Treaty of Maastricht defined the criteria for monetary integration in Europe. The aim of integration was the creation of a monetary zone and implementation of the new supranational currency, "euro". The abovementioned agreement has determined the macroeconomic characteristics (or the "criteria of convergence"), which the integrating European countries must aim at. As the result, the Treaty of Maastricht has set limits on exchange rate fluctuation of the EU countries. Such fluctuations could be $\pm 2.25\%$ without devaluation of local currencies against currencies of other partner countries during the 2 years prior to entering the monetary union. The state budget deficit could not exceed 3% of the GDP; the state debt was to be kept below 60% of GDP. The parameters for long-term interest rate were determined – not to exceed the average index for three countries with the lowest inflation by +2%. And the rate of inflation could not exceed the average index for three countries with a minimum of inflation by 1.5%.

The high degree of export diversification was typical for EU countries, therefore the criteria of convergence did not include any requirements regarding

the size of gold and currency reserves. What is more, there were no requirements on mutual fixation of local currency exchange rate of countries – the potential participants of a “euro” zone. The requirements of monetary and financial convergence indicated a set of conditions that facilitated common currency and monetary policy among EU countries [9,p. 26].

The Treaty of Maastricht essentially created the basis of common economic and financial policy by the EU countries. The obvious and final goal of said policies was the implementation of a common currency. The exchange restrictions on capital movements were cancelled within the EU in 1992. In 1998 the European Central Bank was established in Frankfurt-am-Main. In 1991 the new currency “euro” was implemented in cashless circulation as a parallel currency in 11 EU countries. The new “euro” currency was used as cash since 2002. Today, the “euro” zone includes 17 EU countries.

The approaches to the monetary integration are described in works of Belorussian and foreign experts in the field of international economy, international financial relations, and their research in monetary and financial integration problems [10;11;12;13;14;15;16;17].

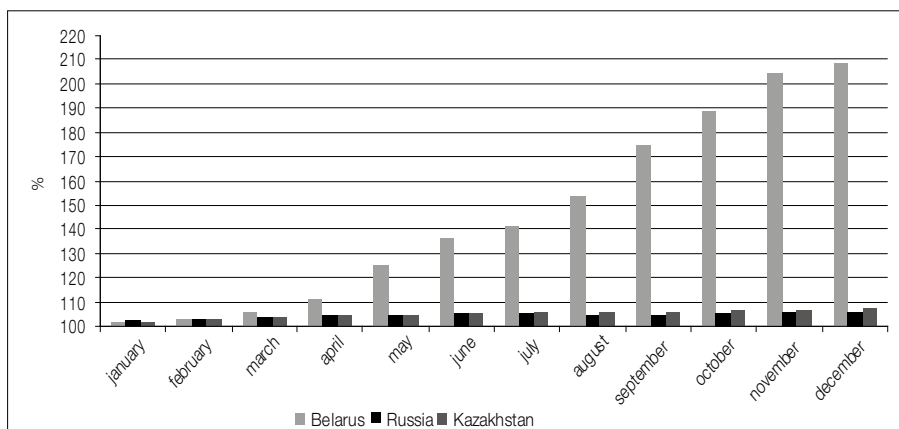
According to the theory of optimum currency areas by Robert Mundell, which was the basis of the European monetary system, the implementation of the common currency was efficient only under certain conditions. These conditions are: the economy and price stability, full employment; labor and capital mobility (inside and interregional); transparency of economy; high share of mutual trade (i.e. goods markets integration of state-participants); regional diversification of production; the high rate of integration in the financial sector; adjustment of the inflation rate; similarity of taxation mechanism and state transfers; flexibility of budget-taxation system and social security, and other conditions [18; 19].

The main factors in the foundation of the monetary union in Europe were:

- *factor mobility* (goods, services, capital and labor) between two countries.

A mutual trade and economic cooperation was typical for Western European countries. EU member-states maintained a policy of trade liberalization, which

Figure 4. The dynamics of consumer price index for goods and paid services for the public in CIS-countries (2011 in % by December 2010)



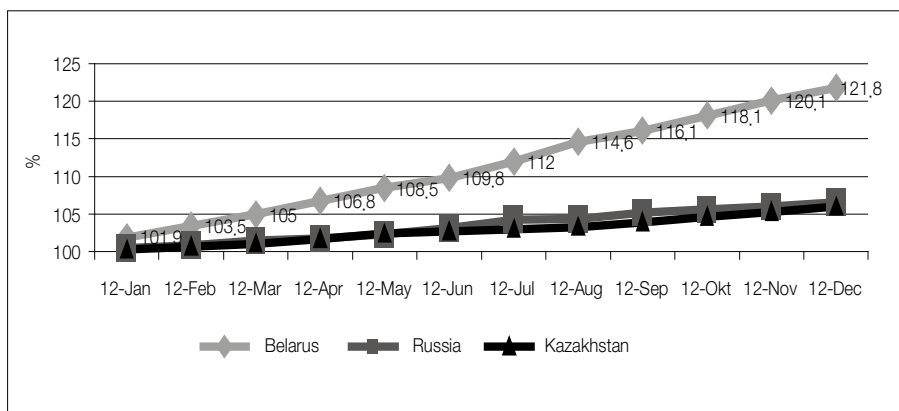
created favorable conditions for capital and labor movement.

- *active use of local currencies in service of mutual trade and economic relations.* In EU countries, the calculations were made regarding the proportion of local currencies in foreign economic operations. (In the middle 90s the largest EU countries (Germany, Britain, France, Italy, and the Netherlands) conducted 40% to 75% of national exports and 40-50% of imports in local currencies).

- *secure long-term stability of local currencies rates relative to each other.* Western Europe countries have been coordinating monetary policy for 25 years. First, there was a currency snake mechanism, and thereafter an exchange rate mechanism of the European monetary system and finally, the monetary union through the implementation of common currency [20, c. 51].

Beginning from 2013 Belarus, Russia and Kazakhstan will also have to follow certain parameters regarding external public debt ($\leq 50\%$ GDP), budget deficit ($\leq 3\%$ GDP) and inflation (\leq a parameter of the country with the least inflation plus 5%).

Figure 5. The dynamics of consumer price index for goods and paid services for the public in CIS-countries (2012 in % by December 2011)



So, the Maastricht convergence criteria were taken as the basis of integration as well.

The analysis shows that Belarus and Kazakhstan does not satisfy fully the Maastricht criteria. The dynamics of consumer price index for goods and paid services for the public in 2011 in Kazakhstan, Russian and Belarus is represented in the picture 4.

The highest growth rates of consumer price index in 2011 were in the Republic of Belarus (208,7% by December 2010). Such high inflation rates in Belarus will complicate the integration processes of the CES countries. In Russia, the growth rate of consumer price index in 2011 amounted to 106.1% by December 2010. The figure was 107.4% in Kazakhstan.

The situation related to the consumer price index has stabilized in Republic of Belarus in 2012 (Figure 5)

The forecast level of inflation in 2012 was:

- Belarus 19-21%,
- Russia 5-6%,

Table 1. The dynamics of international reserve assets of Russia, Kazakhstan and Belarus in 2009-2012.

Date	International reserve assets, USD mln.		
	including:		
	Russia	Kazakhstan	Belarus
01.01.2009	426281	19872	3061,1
01.01.2010	439450	23091	5652,5
01.01.2011	479379	28275	5030,7
01.01.2012	498649	33691	7915,9
01.01.2013	537818	28280	8095.0

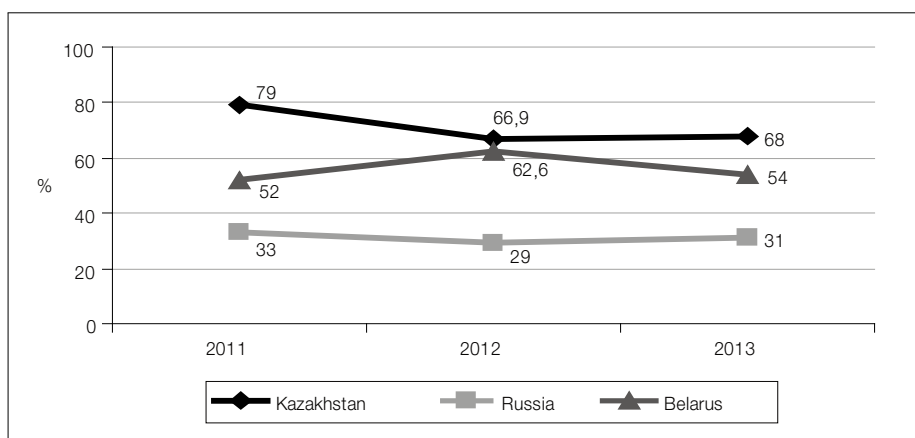
- Kazakhstan 6-8%.

However, Belarus could muster an inflation level of 6% in 2014-2015 only.

The sufficiency of gold and currency reserves is very important for CES-countries. The sufficiency of gold and currency countries reserves is determined by the amount necessary to ensure payment for imports and fulfillment of external obligations. According to the IMF methodology, the amount of reserves equal to six months of imports is recommended for the countries that export goods with high volatility in prices.

However, the level of gold and currency reserves (international reserve assets) in Belarus was not sufficient to cover even three months' import of goods, and remained low for a long time. In 2011 the reserves actually covered less than 2 months of goods imports. The situation became better in December when government authorities in Belarus sold the shares of JSC "Beltransgaz" to Russia. As the result, as of January 2012, the international reserve assets amounted USD 7915.9 million (table 1). In comparison, the gold and currency reserves in Russia are sufficient to cover about 14 months of goods import. The reserves in Kazakhstan are sufficient for 7 months. Thus relative to Belarus, Kazakhstan and Russia have a stable and positive balance of foreign trade.

Figure 6. The dynamics of indicators of "the ratio of external debt to GDP" in Russia, Kazakhstan and Belarus in 2011-2013 (as of 01.01)



Belarus obviously needs make some hard decisions regarding the adequacy of its gold and currency reserves. This is all the more necessary as most calculations and payments for international economic operations are made in U.S. dollars. Meanwhile, Russia and Kazakhstan are the largest trading and economic partners of Belarus. The foreign trade turnover of the Republic of Kazakhstan with Russia and Belarus in 2012 was about 18% of the total foreign trade. The foreign trade turnover of the Republic of Belarus with Russia and Kazakhstan amounted to 48% of the total foreign trade. Exports of Russia to CIS countries amounts to about 16% of the total with imports comprising about 15% of total figures.

Therefore, it might be better to agree with the experts on the necessity of implementation steps to ensure adequate gold and currency reserves, in addition to the Maastricht criteria for CES countries. The given measure is essential in present conditions of export diversification insufficiency.

The dynamics of indicator of "the ratio of external debt to GDP" in Russia, Kazakhstan and Belarus in 2010-2012 (Figure 6) reflects the relative internal stability in the economy of Russia.

This indicator shows the growth of the gross foreign debt of the Republic of Belarus and Kazakhstan, where the above-mentioned parameter is close to the threshold amount for economic security (55% of GDP). The parameters above probably can be added to the integration criteria of CES countries. (For the beginning of 2013 in Belarus the indicator "the relation of an external debt to gross domestic product" decreased to 54%).

3.3. Differences in the currency exchange regulation and specific forms of common monetary policy.

The main differences in measures of currency regulation used by CES countries can be seen in Table 2.

Currency restrictions are widely used in Belarus unlike Russia and Kazakhstan (see Table 2)

Thus, only in the Republic of Belarus are there mandatory sale of hard currency proceeds by business entities (cancelled in Kazakhstan in 1999, in Russia - in 2006), limitations on opening accounts by nationals in foreign banks, requirements for a passport by individuals (nationals and non-nationals) when buying foreign currency through banks.

The foreign exchange regime involves a number of significant restrictions in the current account of balance of payments (the terms for termination of foreign trade operations are limited; the criteria for permission of advance payments for imports are set; there are mechanisms for special-purpose buying of foreign currency at the domestic foreign exchange market) in the Republic of Belarus.

According to information from central (national) banks, there are specific regulatory requirements for transfers of individuals' funds in CES countries.

The cross-border money transfers (foreign currency and RUR) can be made without any restrictions in the Russian Federation. The only exception is money transfers in foreign countries without opening bank accounts by nationals and

Table 2. Comparative analysis of currency exchange regulation areas in the CES countries

Currency exchange regulations	The Republic of Belarus	The Republic of Kazakhstan	Russian Federation
Definition of the currency exchange regulation areas and acceptance of specific instructions	The National Bank of the Republic of Belarus	The National Bank and the Ministry of Finance of the Republic of Kazakhstan	The Central bank of Russia and the government of Russian Federation
Exchange rate regime	Managed float of the exchange rate	Managed float of the exchange rate	Managed float of the exchange rate
Limitations on the current foreign exchange transactions, including	Applied	None	None
1. Limitations on the amounts of advance payments related to imports of goods and services	Applied	Does not apply	Does not apply
2. limitations on opening accounts by nationals in foreign banks	Only with permission of the National bank	None	None
3. Buying and selling by individuals (nationals and non-nationals) the foreign currency through banks	Without limitations on the amounts, only with passport	Without limitations	Without limitations
4. Buying and selling by business entities (nationals) the foreign currency through banks	The purpose of the purchase; use within 7 days	Free	Free
5. Limitations on opening accounts by non-nationals in domestic banks	None	None	None
6. Operations concerning with capital movements	Only with permission of the National Bank	The National Bank needs to check the validity of transaction (exchange agreement)	Without permission of the Central bank

non-nationals of Russian Federation, which are limited to an amount not exceeding the equivalent of five thousand U.S. dollars.

In accordance with the effective currency law of the Republic of Belarus the private transfers of individuals not related to their business activities are not limited by the amount of payment and are realized without restrictions

Moreover, individuals – residents of Republic of Belarus have to get permission from the National Bank of Belarus while making a number of exchange transactions connected with the movement of capital (purchase of real estate, stocks, shares in the authorized capital of non-nationals, etc.).

According to the rules of exchange in Kazakhstan, transactions and cross-border transfers of individuals are realized without restrictions both through accounts opened at authorized banks, and without having to open an account in the Republic of Kazakhstan. The authorized banks provide the information to the National Bank on a monthly basis on payments and money transfers without opening an account and by card payments of over 10,000 U.S. dollars, and when transferring money by bank accounts exceeding 50,000 U.S. dollars.

The central banks of CES countries and especially the National Bank of the Republic of Belarus must coordinate the use of currency restrictions. At the same time, the Republic of Belarus wants to maintain a rule for 30% compulsory sale of foreign currency up to January 1, 2017. Moreover, Belarus wants to safeguard the restrictions on opening accounts in foreign banks, and to conduct capital foreign exchange transactions. But as per CES, the arrangements provide other terms - January 1, 2013. Consequently, the actions on this issue from the Belarusian side are different from the provisions of the Agreement, according to which the parties should ensure the gradual removal of restrictions with respect to the foreign exchange transactions and opening or keeping of accounts by nationals in banks at the territory of CES countries. Pursuant to the established rules, the implementation of currency restrictions is possible in exceptional cases (negative dynamics of balance of payments, size reduction of gold and foreign currency reserves lower than the acceptable level, sharp fluctuations of exchange rates) for

a period not exceeding one year. That is, currency restrictions are permitted in cases where a negative situation can not be changed by other economic measures and policies.

The currency restrictions on capital movement implemented in Belarus helped minimize the risks while allowing foreign economic operations by Belarusian nationals. Nevertheless, the restrictions need to be phased out gradually within the agreements of CES countries.

Any steps taken to abolish the currency restrictions will bring the expected benefits only if the state carries out the complex measures for improving the state of its economy as a whole, including the fight against inflation and the improvement of foreign exchange, tax and customs regimes.

3.4. The directions of monetary policy development within the CES.

The Agreement on Coordinated Principles of Monetary Policy of Common Economic Space countries [21] was signed in December 2010. The given agreement provides for the adoption of monetary policy by the parties based on the principle of gradual harmonization. The monetary policy of countries should be aimed at building confidence in local currencies both in every state-participant and at the international currency markets. The major aims of the agreement are that the CES countries should:

- coordinate the exchange rate policy to expand the use of local currencies in mutual payments;
- ensure the convertibility of local currencies in the current and capital transactions of balance of payments. This suggests that there are no restrictions on exchange transactions for nationals;
- create the conditions for mutual direct quotations of local currencies;
- avoid a multiplicity of exchange rates;

- set the official exchange rate on the basis of rates formed in the exchange market (or on the basis of rates against the U.S. dollar);
- form an integrated currency market;
- arrange the access for banks of CES countries at the national foreign exchange market for interbank FX transactions on terms no less favorable than for native banks;
- create conditions for the allocation of foreign-exchange holdings of CES countries' central banks in the local currencies of participating countries, including also public securities.

Thus, the necessity of keeping the exchange fluctuations of the currencies relative to each other within a limited range are the primary obligation of CES countries under the Agreement. The interpolated values of possible fluctuations had to be coordinated till January 1, 2013. If the deviation of the exchange rate of one of the CES countries approaches the critical point, the central banks of the three countries will have to intervene jointly. In these new conditions, the Republic of Belarus will not be able to take independent decision on the devaluation of the Belarusian ruble against the U.S. dollar, without coordinating its implementation with the CES countries.

The high dollarization of mutual payments and the low proportion of local currencies in the mutual payments is the main problem in the currency payment relations of the CES countries today. At the same time, the share of Russian rubles in trade among CES countries amounts about 20%. It is essential to increase the share of payments in local currencies in terms of the foreign economic turnover of three countries. This will help increase their foreign trade turnover, the economic growth, and the utilization of integration benefits use.

Today the currencies of the CES countries are exchanged with each other primarily through the U.S. dollar. This situation leads not only to excessive growth of transaction costs, but also to foreign currency risks, as partners of the two countries become dependent on the U.S. dollar dynamics in the international monetary markets. The CES countries should ensure the mutual convertibility of

the currencies. As a result, the participants of foreign economic relations could use the local currencies in mutual payments. They could reduce the cost of bank charges and significantly minimize the necessity for hard currency [22;23].

Therefore, **in the short term, the most important measures in the sphere of monetary and financial cooperation of the CES countries should be as follows:**

1. The expansion of the use of local currencies use in mutual trade. It is necessary to create conditions conducive to conclusion of contracts in local currencies. The system of current exchange rate quotations of local currencies of Belarus, Russia and Kazakhstan is not suitable.

2. The establishment of a consolidated monetary and financial market and information market of three countries that will strengthen the competitive positions of national enterprises.

3. Realize unification of rules of the exchange transactions both for nationals and for non-nationals in three counties is required.

The next step after the abolition of currency restrictions should be the development of a common payment instrument.

Development of a common payment instrument. At this stage there should be no questions regarding the implementation of a common supranational currency. Nevertheless, the common unit of account can be used in trade among the CES countries and the accumulation of reserves (example: ECU –European currency unit). At the same time there is no need to refuse the local currencies. Extension of the term for abolition of existing currency restrictions by Belarus up to 2017 will make the development of a common payment instrument difficult.

The common payment instrument will serve the foreign trade turnover of countries well and serve as an instrument for realization of a common monetary policy. The use of a common payment instrument will also create opportunities for settlement system working on export-import transactions among the CES countries.

Table 3. Positive and negative consequences of implementation of the Russian ruble as the CPI for the Republic of Belarus

Negative consequences	Positive consequences
<ol style="list-style-type: none"> 1. Long-term decreases in price competitiveness of Belarusian exports 2. The displacement of the western imports by Russian imports 3. Loss of ability to control the basic monetary indicators 4. Limitations imposed on government expenditure policy 5. Loss of seigniorage 6. Disables Monetary financing of government programs 7. Giving a subordinate character to the Belarusian economy 	<ol style="list-style-type: none"> 1. Minimal organizational, legal and time expenditures for establishment of a Monetary Union 2. The structural simplicity of the construction of a monetary union infrastructure 3. Immediate removal of external barriers in mutual settlements of economic entities of the CES counties. 4. Price reduction for imported consumer goods from Russia 5. Production cost reduction for Belarusian products 6. Increase of foreign trade turnover with Russia 7. Wage growth 8. High stability of exchange rate formation

It is possible:

- to use the monetary unit of one of the CES countries as a common payment instrument;
- to use a new currency as a common payment instrument.

There is the possibility of using the Russian ruble as a common payment instrument (CPI).

In the case that the Russian ruble is used as a common payment instrument, the following positive and negative consequences for the Republic of Belarus can be highlighted. These consequences will be approximately the same as expected to be for the adoption of Russian ruble as the common CES currency within the Union State of Belarus and Russia in 2004 (Table 3) [24, p. 116].

The positive effects of Russian ruble implementation as a common payment instrument for the economy of the Republic of Belarus may show up for the short term. At the same time, in case of negative effects, they will lead to negative impact in the long-run. With respect to this case, the situation is similar in Kazakhstan. Therefore, the use of the Russian ruble as a common payment

instrument for the Republic of Belarus would be undesirable.

The development of the CES will be made most effective by using a new supranational currency as a common payment instrument.

It is possible to establish something akin to the European Central Bank, in the form of the so-called Central Bank of CES, which would act as the emission center.

The membership should consist of representatives of the three countries. The coordination of legislation related to the banking sector, as well as the securities markets in Belarus, Kazakhstan and Russia is required.

Thus, the process of monetary integration in the CES may be conducted in three phases:

- 1) realization of cooperation during the arrangement of payments between the three countries, the coordination of currency and monetary policies. Russian banks have already entered the markets of the CES partners, looking to buy shares in their credit institutions. Thus, the Sberbank of Russia bought 93.27% shares of JSC "BPS-Bank", which was renamed in JSC "BPS-Sberbank" from October 2011;

- 2) coordination of exchange rate policies, development of a common payment instrument and creation of the CES Central Bank;

- 3) adoption of a common currency and establishment of the monetary union.

The establishment of a common monetary area (Stage 3) is possible only in the long-term perspective. The problems that appeared EU should serve as benchmarks to consider while developing the common monetary area. The crisis has shown, it is useful for countries to handle the emission on their own so that in case of crisis there was an opportunity to devalue the local currency and minimize the problems with the budget deficit and public debt.

IV. Conclusions

1. Distinguishing types of exchange rate regimes: fixed exchange rate regime, float exchange rate regime, and transitional regimes i.e. use of broader classification will simplify the conditions for the analysis of exchange rate formation undertaken by the countries. The essential condition for the float exchange rate regime transition is the development of a favorable institutional environment and financial instruments usage for foreign currency risks hedging, as well as achieving sufficiently low inflation rates.

2. The managed float exchange rate regime implemented by the National Bank since the beginning of 2012 should ensure the stability of the exchange rate.

In accordance with the approved Agreement, at the first stage of integration Russia, Belarus and Kazakhstan should coordinate the interval quantities of the local currency exchange rate against the US dollar (or Euro) for a three-year period. The index of real effective exchange rate of the currency of each of the three countries will be used for monitoring in order to determine the degree of integration. In the future the real effective exchange rate of the local currency in Belarus should be depreciated so as not to reduce the competitiveness of goods producers and to increase export effectiveness.

3. The foreign exchange regime involves a number of significant restrictions in the current account of balance of payments (the terms for termination of foreign trade operations are limited; the permission criteria of advance payments for imports are set; there are mechanisms for special-purpose buying of foreign currency at the domestic foreign exchange market and a mandatory sale market) in the Republic of Belarus.

4. Pursuant to the established order, the implementation of currency restrictions is possible in exceptional cases (negative dynamics of balance of payments, decrease in gold and foreign currency reserves to lower-than-acceptable levels, sharp fluctuations of exchange rates) for a period not exceeding one year. That is, the use of currency restrictions is permitted in cases where a negative situation

can not be changed by other measures of economic policy. The central banks of CES countries and especially the National Bank of the Republic of Belarus must coordinate the use of currency restrictions.

5. Maintaining the exchange fluctuations of the currencies relative to each other within a limited range is the primary obligation of CES countries under the Agreement. If the deviation of the exchange rate of one of the CES country approaches a critical point, the central banks of the three countries will have to conduct joint interventions. In new conditions, the Republic of Belarus will not be able to take an independent decision on the devaluation of the Belarusian ruble against the U.S. dollar, without coordinating its implementation with the CES countries.

6. It is essential to increase the share of payments in local currencies in the foreign economic turnover of three countries. The CES countries should ensure the mutual convertibility of their respective currencies.

7. Along with the establishment of the CES central bank the methodology of local currency exchange rate determination should be defined. The development of mechanism for determination of the exchange rate of local currencies against the common payment instrument is necessary.

Then the participating countries of CES can set the exchange rates of the local currencies against other currencies, and against unified payment instrument (UPI) on the basis of a common approach.

8. The process of monetary integration and the establishment of common monetary area within CES can be realized in three stages:

1) Cooperation in the field of payments between the countries, coordination of monetary and currency policy;

2) Coordination of exchange rates policy, development of a unified payment instrument, and creation of a CES central bank;

3) Implementation of a common currency and establishment of a monetary union. The establishment of a common monetary area is possible only in the long-term perspective.

9. The most important measures of the currency policy in Belarus in the short term should be as follows:

- Ensure convertibility of local currencies in the current and capital transactions of balance of payments. This suggests that there are no restrictions on exchange transactions for nationals and non-nationals.

- Maintenance of gold and exchange currency reserves of the state at a level conducive to economic security of the country.

- Use of the flexible mechanism, to maintain stability of the rate of national currency

- Avoid a multiplicity of exchange rates, ensure uniform exchange rate.

- Maintenance of internal stability of national currency will create preconditions for maintenance of stability of the exchange rate.

- The real effective exchange rate of the local currency should be depreciated so as not to reduce the competitiveness of goods producers and to increase export effectiveness.

References

Smirnov, S. 2010. "The exchange rate regime and the economy stability."

Economy questions. №1, pp. 29-41.

Pischik, V. 2011. The evolution of the exchange rate regimes in contemporary conditions/ *Bankovskoe delo*. №2, pp. 17-20.

Lobanov, A. 2008. The analysis of the. exchange rate regulation systems *Bankovsky vestnik*. pp. 10-19. (June)

Shambaugh, J. 2004. "The effect of fixed exchange rates on monetary policy" *The Quarterly Journal of Economics*, №119(1), pp. 301-352.

Shevchuk, I. 2011. "On theoretic approaches to a exchange rate policy modification." *Dengi i kredit*. №4, pp. 50-55.

- On calculation and use of a real exchange rate (electronic means) - library.by/portalus/modules/ruseconomics/referat-readme.php. – the date of access: 01.09.2011.
- Gambarov, G. 2011. The approaches to the estimation of equilibrium exchange rates and external cost of a currency. *Dengi I kredit*, №5, pp. 58-62.
- Mundell, R. 1997. “Theory of optimum Currency Areas.” *American Economic Review*. 1961. Quoted from optimum Currency Areas. IMF. Washington (D.C.), p. 24.
- Shegoleva, N. D. Balashov Monetary union: development of optimal “convergence criteria” / N. Shegoleva, D. Balashov// *Finance and credit*. – 2010. - – №26. p. 21-28.
- E. Zhukov International economic relations: teaching aid/ E. Zhukov. – M: Uniti-DANA, 2000. p. 485.
- L. Krasavina International currency and credit and financial relations: teaching aid/ L. Krasavina. – M.: Fiance and statistics, 2005. – 576 p.
- S. Moiseev International currency and credit relations: teaching aid/ S. Moiseev 2nd edition, revised and updated- M.: DiS, 2007. p. 816.
- Faminskiy International economic relations: teaching aid/ I. Faminskiy. M.: The Economist, 2004. p. 645.
- T. Alekseeva Common monetary area: European experience/ T. Alekseeva// *Finance and credit*. 2008. № 23. pp. 75-77.
- V. Mamakin An international role of Euro: presence and future. / V. Mamakin// *Foreign economic newspaper*. 2005. № 4. pp. 61-65.
- A. Menshikova The dynamics of the common currency impact of Europe in its economic relations with the USA/ A. Menshikova *USA*Canada: economy, politics, and culture*. 2006. №9. pp. 19-34.
- Y. Ofmanis Euro does not have such a high-quality base as a dollar./ Y. Ofmanis// *Finance and credit*. 2006. № 36. pp. 31-45.
- D. Kondratov Eurozone: monetary policy in the crisis conditions / D. Kondratov// *The economist*. №3. 2010. pp. 75-83.

- Y.Riabysheva European monetary and financial integration and the prospects for the use of its experience in the Eurasian region: summary of PhD thesis: 08.00.14 / Y.Riabysheva. M., 2007. p. 28.
- V. Sokolov The zone of euro: the modern stage/ V. Sokolov// Money and credit. 2011. №8. pp. 46-52.
- The Agreement on the coordinated principles of monetary policy: The law of the Republic of Belarus dated 28.12.2010 №212-3.
- M.Petrov, D. Plisetskiy The opportunities and prospects of CIS countries integration in the financial sector/ M.Petrov, D. Plisetskiy// Finance and credit. 2011. №8. pp. 38-48.
- N. Raskov Foreign trade imbalances and monetary policy/ N. Raskov// The Economist. 2011. №1. pp. 33-41.
- A. Petrovich Monetary integration of the European Union: Experiences for the CIS countries/ A. Petrovich. – Minsk: Foreign Ltd “Law and Economy.” 2004. p. 160.



4

Services Sector in India and India-Korea Economic Cooperation

Sandip Kumar Mishra¹⁾

Introduction

The significance of services sector, in terms of global economic activity, has increased significantly and it currently constitutes the largest sector in the world economy. The services now contribute 68 percent of the total gross domestic product (GDP) of the world. Furthermore, there are estimates that with the transformation of industrial society to post-industrial society or information society, the share of services would increase more than has ever been envisaged in the history of mankind. For example, the earning from the blockbuster Hollywood movie like *Avatar* has been estimated at around \$3 billion, which is much more than the annual turnover of many important manufacturing companies. The example is not intended as a belittlement of industrial and manufacturing sectors, but simply underlines the changing contours of global economics.

The general pattern of economic development has been that the countries move from the agriculture to manufacturing, and ultimately to services. However, there

1) Sandip Kumar Mishra is an assistant Professor of Korean Studies at University of Delhi, India.

are few examples where the services sector became robust in the economy without sufficient growth in the industrial sector. India is one of these countries where the growth of the services sector has been spectacular without sufficient increase in the manufacturing sector. The Indian economy has moved from being an agriculture-dominated economy to one dominated by services, bypassing the intermediary phase of industrial and manufacturing dominance in economic activities.

There are serious questions being raised about the rise of India in the global services sector, as it is considered premature and lacks the foundation of a strong industrial infrastructure. However, there are speculations that the transformation is positive, as, most of the countries would gradually specialize in only few of their 'core competences' in a globalized world economy, leaving other economic activities subordinate to the core. Also there could be positive spillover of growth in the services sector, as the pull factor created by the services sector might help them to become stronger in future.

The performance of India in the services sector of its economy is quite impressive. Although the share of services in the GDP is around 57 percent in India, which is less than the US and several European countries where it is around 78 percent, it is definitely higher than several other emerging developing economies such as China where it is around 41 percent. India ranks 8th and 11th in the overall GDP and services GDP, respectively, among the top fifteen countries with the highest overall GDP in 2010. The share of services sector in the economy has grown 7 percent (From 2001 to 2010), which is one of the highest in the world. Even in 2008-09, when GDP growth was relatively low at 6.7 percent because of the global financial crisis, the services sector in India grew by 9.7 percent. In the same year, the growth rate of exports in services was 12.5 percent.

Indian success story in the services sector have attracted enough attention across the world and several countries have been looking to tap the opportunities created by the process. The history of South Korean economic engagement with India might not be very long, but the synergy between the two economies and

spectacular growth in their economic interaction has been exemplary. The two countries signed the Comprehensive Economic Partnership Agreement (CEPA) in 2009 which came into force from January 2010. The CEPA has further augmented their economic engagement with certain caveats, which needs to be addressed. The paper intends to look at the growth trajectory of the Indian services sector and its role in the further improvement of bilateral economic relations between the two countries. Although it is difficult to define the services sector precisely, the paper has taken a more general and broad-based definition of services sectors, and included the construction sector. The government of India classifies following activities as being in the services sector: construction; trade, hotels, transport, and communications (THTC); Finance, Insurance, Real Estate, and Business services (FIRBS); and Community, Social and Personal Services (CSPS). Whereas the National Accounts of India does not include construction in services sector, the Reserve Bank of India and the World Trade Organization includes construction in the sector; this paper includes construction in the scope of the services sector as well.

Services Sectors of India

The story of the services sector in the Indian economy is a bit unusual. The growth of the services sector in India did not follow the usual pattern in which it has a distinct relationship with the per capita income. The growth of the services sector began accelerating in the 1980s but after the liberalization of Indian economy in 1990s, it has shown a remarkable trajectory of growth even without a proportional support from other sectors of the economy.

There are several technological inducements, which played an important role in the growth of India's services sector. However, three important factors in particular played a critical role in the process - human endowment, government policy and institutions. Without sufficient and skilled human resources, appropriate

Table 1. Composition of Indian Economy

(Unit: %)

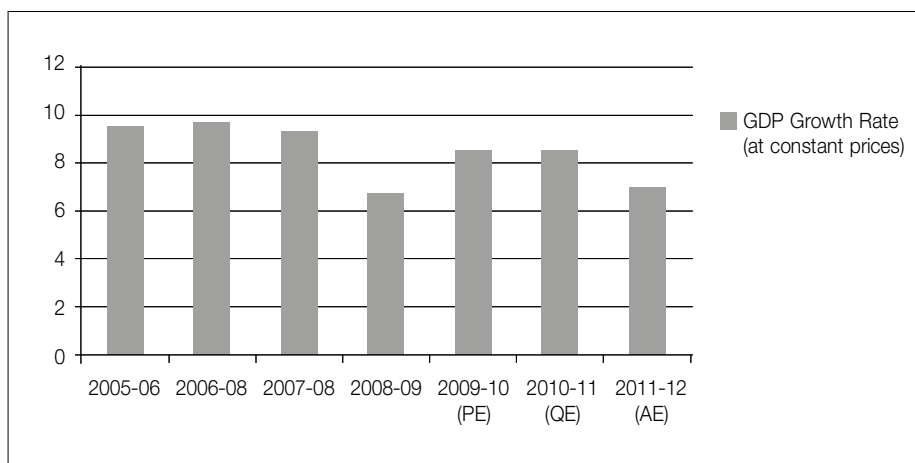
Year	Agriculture	Industry	Services
1951-52	55.4	15.4	29.3
1961-62	49.4	19.5	31.1
1971-72	43.1	22.5	34.5
1981-82	37.6	24.6	37.9
1991-92	30.3	25.6	44.1
2001-02	24.0	25.0	51.0
2009-10	14.3	28.5	57.2

Source: Reserve Bank of India.

and far-sighted policies along with efficient and functional institutions, it would not have been possible for an underdeveloped country like India to emerge as an important economic player in the international arena. The economic, financial and trade reforms and along with growth in IT and ITES provided initial thrust to the process. ITES includes software, and business process outsourcing (BPO), which has made huge contribution to Indian services exports.

During the initial stages of India's planned economic development model, the service was not given sufficient attention; agricultural and industrial sectors were the main focus for the government in its quest for self-sufficiency in food production and import substitution. However, the planned socialist economy of India had a very low growth rate because of structural reasons. Indian policy makers realized the limitations of this model in the 1980s and started exploring with a more liberal economic policy and diversification of economic activities. It resulted in several small but significant attempts to support and nurture computer and other IT services in certain pockets of India. The paradigmatic change in Indian economic policy came in the early 1990s, when country started structural reforms and liberalized the economy. It resulted in improvement in the GDP growth rate of India which reached up to more than 6 percent in the 1990s and before the recent

Figure 1. Indian Growth Performance in Recent Years



slowdown because of multiple internal and external factors, it was growing at around 9 percent, which is probably the highest for any democratic country in the world recently (Figure 1).

Looking back at the economic growth of India over the years, it is quite unusual that the significance of the agricultural sector gradually decreased while the contribution of manufacturing and services sectors increased. However, the Indian story is unique as the services sector literally jumped forward and overwhelmed manufacturing without sufficient shift from agriculture to manufacturing. The share of the agricultural sector which was around 55 percent in 1950s, declined to 19 percent in 2010. The share of industry grew from 16 to 27 percent in the same period. However, the services sector, which was around 26 percent around the beginning of economic planning, reached around 57.4 percent in 2011. Furthermore, over the years the services sector in India has shown a tendency toward diversification; and tourism, airlines and hotels, finance, insurance and banking subsectors have also shown consistent growth patterns along with IT and ITES sectors.

Table 2. Breakup of Services Sector of India

(Unit: %)

Year	THTC	FIRBS	CSPS
1951-52	37.8	25.7	36.5
1961-62	43.4	22.9	33.8
1971-72	43.3	20.6	36.1
1981-82	46.3	20.2	33.5
1991-92	42.1	26.2	31.6
2001-02	45.1	25.9	28.9
2009-10	46.6	30.3	23.1

Source: CSO data.

The share of services was about 33.5 percent in 1950-51 (at current prices) but in the last sixty years, it grew to 64.4 percent. With a 16.9 percent share, trade, hotels, and restaurants as a group is the largest contributor to GDP among the various services' subsectors, followed by financing, insurance, real estate, and

Table 3. Share of subsectors of services in GDP

Sub-sectors	2006-07	2007-08	2008-09	2009-2010 (PE)	2010-11 (QE)	2011-12 (AE)
Trade, hotels and restaurants	17.1	17.1	16.9	16.6	16.9	25.2
Transport, storage and communication	8.2	8.0	7.8	7.8	7.7	
Finance, Insurance, real estate & business services	14.8	15.1	15.9	15.8	16.4	16.9
Community, social and personal services	12.8	12.5	13.3	14.5	14.3	14.2
Construction	8.2	8.5	8.5	8.2	8.2	8.1
Total	61.0	61.2	62.4	63.0	63.3	64.4

Source: *Economic Survey 2010-12*.

Table 4. Annual Growth in Services Sector

	2005-06	2006-07	2007-08	2008-09	2009-2010 (PE)	2010-11 (QE)	2011-12 (AE)
Trade, hotel and restaurants	12.2	11.1	10.1	5.7	7.8	9.0	11.2
Transport, storage and communication	11.8	12.6	12.5	10.8	14.8	14.7	
Finance, insurance, real estate & business services	12.6	14.0	12.0	12.0	9.4	10.4	9.1
Community, social and personal services	7.1	2.8	6.9	12.5	12.0	4.5	5.9
Construction	12.8	10.3	10.8	5.3	7.0	8.0	4.8
Total Services	11.1	10.1	10.3	9.4	10.0	9.2	8.8
Total GDP	9.5	9.6	9.3	6.7	8.4	8.4	6.9

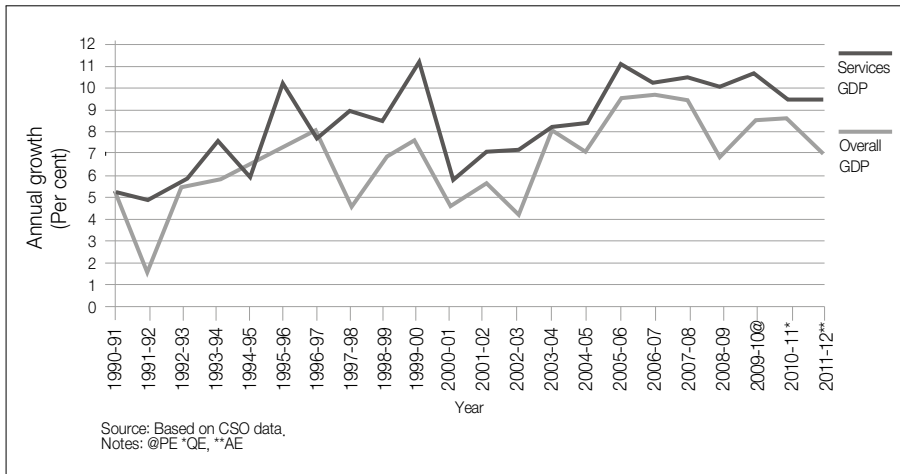
Source: *Economic Survey 2010-12*.

business services with a 16.4 percent share. In third place is community, social and personal services with a share of 14.3 percent. Construction, a borderline service industry, is at fourth place with 8.2 percent. In the last 15 years, the growth of the services sector in India has been higher than the overall GDP growth rate of the economy, except for 2003-04 when the two were about the same.

In the years 2009-10 and 2010-11, the services sector has grown at 10.0 and 9.2 percent, respectively, and in 2011-12, it was expected to grow by 8.8 percent. This shows that growth in the services sector has been much more stable than those of agricultural and industrial sectors of the Indian economy.

The significance of the Indian services sector in the economy is also obvious from the fact that India was ranked 10th in exports of services across the world, while its rank was 20th in merchandise exports.

Figure 2. Growth in overall GDP and Services GDP



Source: *Economic Survey 2010-12*.

Table 5. Share of India in services exports in the world

Year	Indian Services Exports (%)	Total Export (%)
1990	0.6	0.5
2001	1.2	0.7
2009	2.6	1.2
2010	3.0 (4.4)	

According to World Trade Report, India exported services worth \$110 billion last year. Thus, Indian share in total world services exports increased from 2.6 percent in 2009 to 3.0 percent in 2010.

The trend over the last two decades has been clear – India's share in the world services trade grew faster than its share in overall global trade. As per the BOP data of the RBI, India's services **exports** grew at a CAGR of 20.6 percent

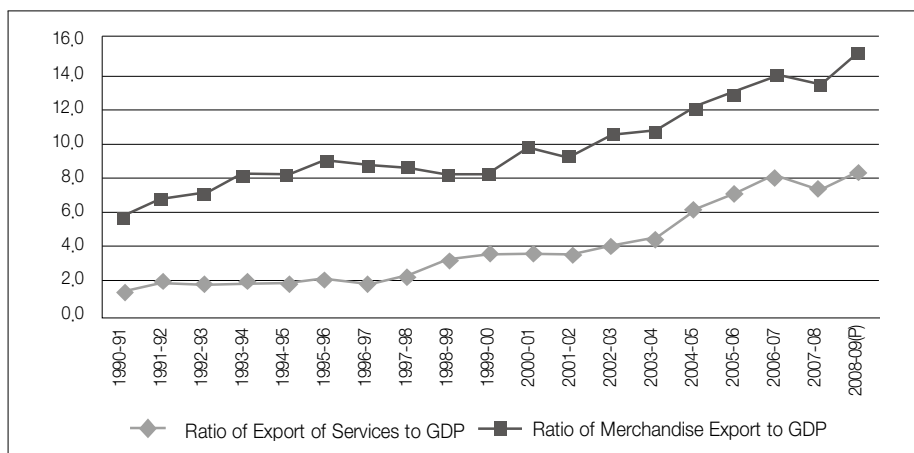
during the period 2004-05 and 2010-11, compared to the 19.7 percent CAGR in merchandise exports in the same period.

Table 6. Services growth faster than merchandise trade in India

		Export Volume (\$ billions)		
		1991	2001	2008
Exports of goods	World	3494.03	6141.93	16031.30
	India	17.87 (0.512 %)	45.43 (0.740 %)	177.70 (1.108 %)
Exports of services	World	853.16	1522.19	3858.58
	India	4.93 (0.577 %)	17.34 (1.139 %)	102.95 (2.668 %)

Source: IMF, *Direction of Trade Statistics online*.

Figure 3. Goods and Services exports as a percentage of GDP

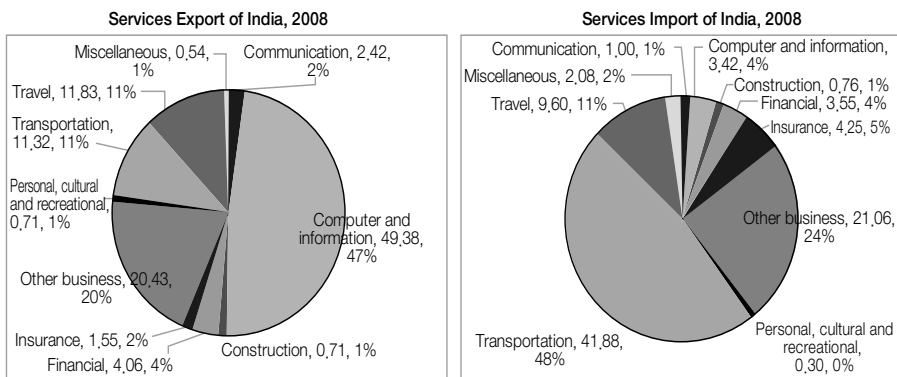


Source: CSO data.

Table 7. Exports of Indian services sector faster than imports

Year	Exports (% billion)	Imports (% billion)	Total (% billion)
1991	4.925	5.945	10.871
1998	11.691	14.540	26.231
2001	17.337	14.483	31.820
2002	19.478	15.034	34.512
2003	23.902	17.425	41.326
2004	38.281	25.205	63.486
2005	52.527	32.549	85.076
2006	69.730	40.324	110.054
2007	86.965	47.592	134.558
2008	102.949	56.554	159.503
2011-12	138	82	220
Average annual growth rate (%)			
1991-1998	19.62	20.65	20.19
2001-2008	70.54	41.50	57.32

Source: IMF, Direction of Trade Statistics online.



Note: *Taken at current price

Source: Calculated based on Direction of Trade Statistics Online, IMF

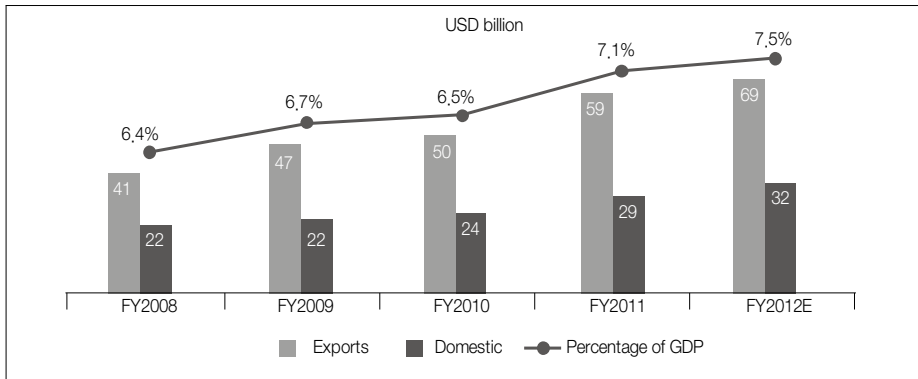
Within the services sector, CAGR of financial services (29.2 percent) were higher while the software at was comparatively lower at 21 percent. In terms of size, software is a major services export category, accounting for 41.7 percent of total services exports in 2010-11. Among services imports, non-software services (22.6) and transportation (20.5) showed a high CAGR. The overall openness of the economy is reflected by total trade including services as a percentage of GDP showed higher degree of openness at 50.3 percent in 2010-11 compared to 25.4 percent in 1997-98. The degree of openness was lower in merchandise trade at 37.5 percent. According to general volume, the exports of Indian services have increased six and a half fold in last decade (from \$20 billion in 2002 to \$138 billion in 2011)

With respect to Indian exports basket, services constituted 20 percent of the basket in 1990 and the figure has gone up to 59.2 percent in 2008. As mentioned in the previous section, the success of the services sector in India is greatly attributed to business services (which includes software and ITES), which made up 67.8 percent of total services exports in 2008. Around half of the world's back office is being located in India and Indian outsourcing revenue in 2011 (\$59 billion) accounted for 51 percent of global offshore market as the sector employed around 10 million people directly and indirectly.

For almost a decade, India has been the second largest exporter of business services among the emerging Asian economies. Indian software accounted for 46.4 percent of total services exports in 2008-09. In computer services, India has emerged as the leading exporter, next to EU and surpassing Ireland and the US. There are several issues related to on-site and off-site services as well as products in physical form or non-physical forms but undoubtedly, India's performance has been more than satisfactory in this services subsector.

Specifically, the role of IT and ITeS which includes BPO has been quite exemplary in the growth of services sector in India. The sector contributed a meager 1.2 percent to the GDP of India in 1998 but its contribution rose to 7.1 percent in 2011. The aggregate business of the IT-BPO sector in India was 88.1 billion

IT - BPO Revenues



in 2011 and around two-third of it was through the exports of these services. There are around 2.5 million people directly employed in the sector along with 8.3 million indirect employments in 2010-11. While there has been a small setback to this services subsector due to the global financial crisis as well as competition from emerging competitors such as China and Chile, it has been growing satisfactorily hitherto. The role of education in general and computer education in particular, along with English being the medium of instruction in most of colleges of India, helped India perform better in IT and ITES.

Indian banking sector also performed satisfactorily with the advent of economic reforms in general and banking reforms in particular. Reform in the financial sector of the Indian economy was being initiated during the first phase of economic reform in the early 1990s. More branches of banks in India were incorporated, with new technology and associated practices in these branches (82485) related to IT and ITES being introduced, helping the growth of the services sector in the country. In the banking sector, there has been a triangular contest between domestic private, foreign and public sector banks. Various services which were non-existent in India, such as DMAT, ATM, Credit Cards, online tracking of stocks, portfolio management became more common and induced initiation of other auxiliary services in the

process. In the 11th plan, the government also tried to include more people within the scope of banking services, which generally benefitted the services industries in India. The target was to connect 73000 villages of India through banking services, and there has been substantial progress at this front.

In the insurance sector of India, there are around 47 insurance companies. After the opening of the insurance sector in India, private and foreign players have been presented serious competition for the existing players and made this particular subsector quite vibrant. The insurance density of life insurance sector has reached \$47.6 in 2009, which was just \$9.1 in the 2001. The insurance penetration has also nearly doubled during the period. India is ranked 9th in the life insurance business despite the fact that the vast majority of Indian population is still not covered by any policy. By looking at the potential insurance market of India, the share of Indian life insurance sector which was 2.45 percent in 2009 is highly under-developed. Similarly, there have been good performances in other subsectors of services. In tourism, the growth of foreign exchange earnings by arrival of foreign tourists to India from 2006 to 2011 has been 14.7 percent and share of hotel and restaurant sector in the overall economy has increased from 1.46 percent in 2004-05 to 1.53 percent in 2008-09. Rate of growth in Indian telecommunications and real estate services has also been positive with lots of unrealized potentials. Various other services such as R&D, legal, consultancy services along with huge opportunities for construction services are there to be tapped in Indian economy.

Issue of FDI in Services Sector

The government appears to be well-informed about the critical role of the services sector in the Indian economy and have taken several steps to inculcate, sustain and accelerate growth as well as diversify and balance subsectors of services

Table 8. FDI inflows in subsectors of services

Ranks	Sector	2009 -10	2010 -11	2011-12 (April- Dec.)	Cumulative Inflows (April 2000- Dec. 2011)	Percentage of Total (in US\$)
1	Services Sector (financial and non-financial)	4176	3296	4575	31710	20.1
2	Telecommunications (radio paging, cellular mobile, basic telephone services)	2532	1665	1989	12544	7.9
3	Computer Software and Hardware	872	780	564	10973	6.9
4	Housing and real estate	2935	1227	551	10933	6.9
5	Construction activities (including roads and highways)	2852	1103	1602	10239	6.5

Source: *Economic Survey 2010-12*.

in the country. It has attempted to open more and more items in the sector to foreign direct investment (FDI), varying in percentage from 26 percent in the print media to 100 percent in information technology (IT) sector, business process outsourcing (BPO) sector, e-commerce activities, infrastructure etc. The government also appears to be committed to FDI in the retail sector but has been facing strong opposition from several specific quarters. In January 2012, government allowed 100 percent FDI in single brand retail which was 51 percent in the past.

As IT and ITeS constitute one of the most important subsectors in the services, the Indian government has taken measures to strengthen related and auxiliary services such as the telecom sector by making it more affordable and wide-spread within the country. There have also been attempts to connect various services such as banking, finance, and other information-based services for a seamless interactions and mutual strengthening. India is considered to be a top destination for off shoring as per Global Services Location Index 2007.

Table 9. FDI Policy for the services sector

Limit	Categories	Routes
Up to 26%	<ul style="list-style-type: none"> • FM Broadcasting (20%) • Up-linking news and CATV Channel • Print Media- Newspaper and Periodicals • Insurance 	FIPB FIPB FIPB Automatic
Up to 49%	<ul style="list-style-type: none"> • Broadcasting- Cable Network, DTH, Setting up hardware • Stock Exchanges • Air Transport Services 	FIPB FIPB Automatic
Up to 74%	<ul style="list-style-type: none"> • Telecommunication • Private Sector Banks 	FIPB (Beyond 49%) Automatic
Up to 100%	<ul style="list-style-type: none"> • Development of Existing Airports • Publication of Scientific Magazines • Courier Services 	FIPB (Beyond 74%) FIPB FIPB

Issue of Employment

Service sector in India has emerged as the second largest sector in terms of providing employment (including construction) after agriculture. However, the numbers employed in this sector is not proportional to its contribution to the GDP of the country. Services sector contributed around 57 percent to the GDP of the country but according to the NSSO report in 2009-10, it contributed only 46 percent employment in rural and urban areas. However, if we divide the figure into urban and rural areas, around 68 percent of urban populations are employed in the services sector of India. The employment opportunities in services sector are also not evenly distributed and there are variations in the figures by subsector and regions. As we know there was a sharp decrease in the employment elasticity of growth in the post-Reform period in India - it dropped from 0.40 to 0.15 by 2000 - but in the last decade the trend has been reversed and the figure reached up to 0.51 in 2005. The general trend of employment generation in most of the subsectors of services has been positive in this period.

There are also lots of employment opportunities created by the services sector, which are in less-than-organized subsectors as well as being circumscribed. There are more informal employment offering high payment but do not have regular work hours and schedules. It also requires skilled people in that particular profession. For example there are reports that though there are many unemployed people in India, many services sector companies are having problems finding right people for their jobs. Thus, it is incumbent on the state to put in place an appropriate policy for human resource development, especially in vocational and higher education sectors as well as connecting human resources to the job market through better organization of the liaison.

Challenges and Prospects in the Indian Services Sector

The services sector of India appears to be vibrant and sustainable but there are some serious challenges which need to be overcome. One of the challenges is under-developed infrastructure- social, physical and even IT. The second big challenge to the growth story of the Indian services sector could be identified as insufficient reforms in several areas including labor, finance, education, legal and administration; where reforms in most of the cases are non-existent or less than adequate. In the wake of the global financial crisis, economic upheavals and market protectionism, the Indian services sector would have to face serious challenges. Furthermore, the initial benefit of low labor cost and lack of competition have gradually changed or changing, it would be interesting to see how India copes with such a situation. Creating as well as sustaining a favorable business environment with sufficient level of trust in Indian economic performance would be very critical in coming years to the services sector of India.

All problems and challenges to the Indian services sector could be boiled down to the issue of generating sufficient political will on the part of the

government, to provide sufficient and timely support through its policies. To sustain growth in the services sector, the government must have the resolve to provide human endowment, arbitrating institution and policies in a more coordinated manner while keeping long-term course and targets in mind. The government of India has already taken various steps in this direction including signing of bilateral and multilateral trade agreements against protectionism and reduction of tariffs for trades of goods and services. In this regard, India signed free trade agreements with a number of partners such as the Comprehensive Economic Partnership Agreement (CEPA) with South Korea in 2009. However, a single measure would not be enough and there must be regular reevaluation of their functioning to make them more useful for the services sector in particular and all other sectors of the Indian economy in general. Another challenge to the growth of the services sector could be identified as lack of reliable, compatible and comprehensive data about the sector without time lag. Apart from productivity in the sector, coordination and systematization is also important to recognize problem areas more precisely and in quantitative terms, and take measures to redress those specific problems.

There are lots of unrealized potential in the services sector. For example the main flag bearer of the Indian services sector- IT and ITeS have realized just 10 percent of its potential across the globe and there are at least \$300 billion potential business in the sector which has been untapped till now. Apart from other potentialities, with the general advancement of the Indian economy, a large middle class has emerged in the country which has sufficient disposable income. With urbanization and population bulge in the working age group and the emergence of a variety of unconventional services, the prospect of this sector looks to be quite bright and there are also possibilities that the dominance of this sector would not only further increase but would also provide spill-over effects to agriculture and manufacturing sectors of the Indian economy.

While the generally strong trend of growth in Indian services sectors appears to be continuing, there are certain problem areas which need to be addressed. Since a good amount of portfolio investments are there in India, any instability

in western countries may create problems for India. Indian ITES is also vulnerable to upheavals in the global economy. After the global financial crisis, there has been a slowdown in this sector. The exports in ITES went down from \$44.5 billion in 2008-09 to 41.6 billion in 2009-10. The estimate for 2010-11 is similar. According to NASSCOM, in 2012-13, the growth rate of India's exports of IT services, business process outsourcing and related services may drop to 11-14 percent. It is important to remember that even though ITES amounts to around 5 percent of Indian GDP, its impact on confidence and image is quite huge. Its performance is related to the stock market and other financial activities. With modest recovery of the US economy, the sector felt a sigh of relief last year. There are a variety of activities which are part of the services sector but most notable among them are software, tourism and travel including transport. There are some potential services such as professional services, infrastructure related services and financial services. And last but not the least, BPO.

There are speculations that India's services sector might face serious challenges from several quarters. Although statistics from the WTO indicates that Indian software and IT services exports have been steady so far (4.4 percent), China has been gaining fast in the global commercial services (such as transport and travel) and accounts for 6.1 percent of the global market, and it has changed China's status from a net importer of services to a net exporter. Transportation services imports were around 40 percent of India's total commercial services imports in 2010 and the Chinese advantage might be a matter of concern for India.

Indian services sector represented 56.3 percent of its GDP in 2011-12 but several linkages with global network, given apparent negative trend, could create trouble for the Indian growth story. According to the most recent data released by the Services Export Promotion Council of India, exports in services showed negative trend as the figure fell from \$12.89 billion in March to \$10.48 billion in April 2012.

India-Korea Economic Cooperation

South Korea appears to be interested in tapping economic opportunities in India and the bilateral economic exchanges between the two countries have grown by leaps and bounds in recent decades. The India-Korea bilateral trade which was less than a billion dollar when India liberalized its economy and introduced economic reforms has reached \$20.57 billion in 2011.

The growth has been exponential, as the bilateral trade was \$9 billion in 2006 and it has more than doubled in less than six years. Although the balance of trade has been in favor of Korea, recent data in trade indicate that India is also catching up. Even though the growth in bilateral trade between Korea and India is fast, the trade intensity for India has been below optimum while the opposite is true about Korea. Korea exports manufactured items such as electronic goods, machinery, transport equipment, iron and steel, plastic and organic chemicals and

Table 10. India-Korea Bilateral Trade

(Unit: \$ billions)			
Year	Exports to India	Imports from India	Total Trade
2001	1.41	1.11	2.52
2002	1.44	1.25	2.69
2003	2.85	1.23	4.08
2004	3.63	1.85	5.48
2005	4.59	2.11	6.70
2006	5.53	3.64	9.17
2007	6.60	4.62	11.22
2008	8.97	6.58	15.55
2009	8.01	4.14	12.15
2010	11.43	5.67	17.10
2011	12.68	7.89	20.57

Source: Korea International Trade Association.

they constitute almost two-third of Korean exports. Indian exports items are largely dominated by raw materials and primary goods such as cotton yarn fabrics and made-ups, petroleum products, oil meals, ores and minerals, iron ore and primary and semi-finished iron and steel. It also shows that trade in services for both Korea and India is low. It is 25 percent for India and 16 percent in the case of Korea (2006).

Actually, before looking at the economic cooperation between Korea and India, it should always be kept in mind that the two countries are at different stages of economic development along with different 'core competences'. Whereas per capita income in India is still lingering at \$1527, in case of Korea, it has crossed the \$20000 mark long ago. Whereas India is still a developing economy, Korea has been included in the elite club of developed countries back in 1996 when it obtained membership of the OECD. The economic development model of Korea has been export-led growth, whereas Indian focus has been more on inward-looking growth. Whereas India is rich in human and natural resources along with cheap labor and a huge emerging market, Korea is known for its technology and capital-intensive growth model. The contrast between the two economies makes them perfect partners as both can benefit each other with their cooperation. There might be few cautions in India as the exchange between the two might benefit Korea more than India but in several studies including a study by the Indian government before concluding the Comprehensive Economic Partnership Agreement (CEPA) with Korea, makes it clear that the benefits of economic cooperation between the two countries overrun few disadvantages.

After the opening of the Indian economy, Korean companies realized the potential of the Indian market and became increasingly active. Global Korean giants such as Samsung, Hyundai and LG entered the Indian market and they have outperformed their rivals and growing rapidly. Korean steel maker POSCO has been patiently working to invest \$12 billion in Paradeep, Orissa and it is considered to be the biggest FDI in India. Although there have been several hurdles- technical, legal, political and others in the process of POSCO's investment in India, it is

remarkable that it has been diligently trying to overcome all the obstacles. During the same period, Tata Motors of India and Mahindra & Mahindra have invested in Daewoo and Ssangyong Motors of Korea (102 million and 473 million). Apart from big Korean companies there are around 200 small and medium-size Korean companies who are active in India. The bilateral trade data show that whereas India recorded a surplus in trade in services, Korea had a surplus in merchandise trade. According to one estimate, in the service sector, Korea showed a consistent comparative advantage in transportation services while India did so in IT and software services.

CEPA and Economic Cooperation

To further enhance their bilateral economic exchanges, the two countries began negotiating the issue of free trade in 2004 and after several rounds of talks, the CEPA was signed in August 2009. It was unique for India as it was the first time India signed an FTA with an OECD country. Similarly, it was the first Korean FTA with a BRICS country. In a recent study, it has been predicted that the CEPA would help in terms of more FDI inflows from Korea, trade in services and technology transfer. The CEPA would provide opportunities to medium and small Korean and Indian companies to have joint ventures in various sectors of the economy. Unfortunately, the reduction of tariff barriers are considered to be too slow under the CEPA and there are more to be done regarding cooperation of Korea and India in the financial sector, the overall impact of the agreement has been positive on their bilateral economic engagement. According to the provisions of the CEPA, Korea has to lower or fully eliminate tariffs on 90 percent of Indian goods over 8 years and India has to do so for 85 percent of Korean goods in the same time span. The CEPA would reduce obstacles in the temporary movement of professionals such as computer programmers and engineers to each

other's country. It is encouraging that after the signing of the CEPA, the growth rate in bilateral trade between the two countries have been 40 percent (reaching \$17.1 billion) in 2010 and 20 percent (reaching 20.5 billion) in 2011.

In the very first year of implementation of the CEPA, Indian became the 7th largest trade partner of Korea, surpassing Germany. Korean exports to India grew by 42.7 percent where as imports grew by 37 percent. Both rates are higher than Korea's global exports and imports figures. However, a recent report of KIEP pointed out that CEPA's preferential rates on few items are higher than the MFN rates. The problem needs to be resolved as soon possible. It is good that both countries had the first Joint Committee meeting in March 2011, in which both countries promised to push forward their economic cooperation along the CEPA procedures. They agreed to simplify visa procedure and joint production of broadcasting programs, movies, and animated cartoons. Both the countries expect to increase their bilateral trade by \$30 billion by 2014 or 34 billion by 2015. But if we take into account the CEPA effect, it might reach \$48 billion by 2015.

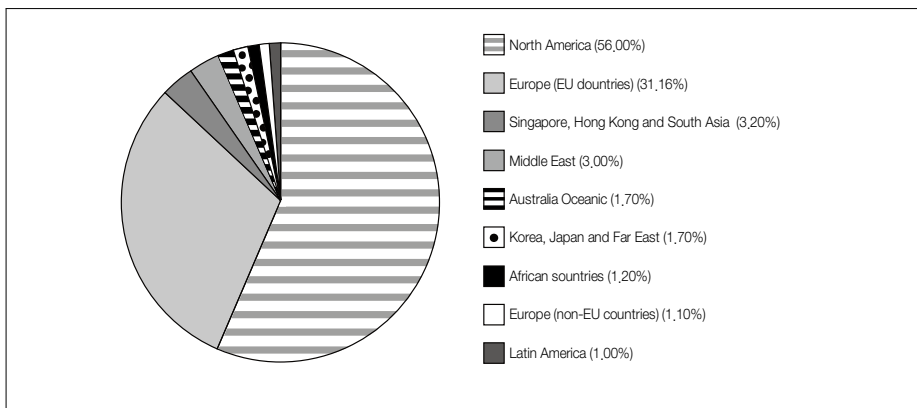
The growth in bilateral trade and investment along with cultural and educational exchange as well as frequent visits of leaders of both countries to the other country makes it obvious that both countries have realized the importance of its partner. Also both of them have been working to establish suitable regimes, institutions and policies to make the most of the potential, but there must be periodic review to see whether these efforts are leading to expected results or whether there needs to be a few changes. There are lots of complementarities between India and Korea, which were responsible for this fast growth in bilateral trade. India's economic growth, as described in the previous section was amply supported by growth in the services sector of its economy, Korean manufacturing sector has been the backbone of Korean economic development after the early 1960s.

Indian Services Sector and Bilateral Cooperation

Although, the bilateral cooperation between Korea and India has been moving ahead satisfactorily, they need to work out further modalities to extend their in-depth cooperation in different subsectors of services, which have huge potential for the future. Korea and India needs to make more precise and directed efforts to cooperate in IT and ITeS subsectors. Unfortunately, little has been done to connect Indian and Korean expertise in this area. Indian IT and ITeS are much more oriented to the North American and European market. Almost of 87 percent of Indian exports are going to these countries whereas the share of Japan, Korea and other far east countries is just 1.3 percent in 2010-11. The two countries need to workout a strategy for more intense cooperation in this field.

Korea has been strong in the computer hardware sector whereas India's strength is in software. During the visit of Korean President Roh Moo-hyun to India in October 2004, both countries pledged bilateral cooperation in the IT sector, and the Electronics and Computer Software Export Promotion Council

Figure 4. Export Destinations for India's Computer Software/ Services Sector, 2010-11
(% share of exports)



Source: ESC Statistical Year Book 2010-11.

(ESC) and NASSCOM signed an MoU with the Korean IT Industry Promotion Agency (KIPA). The two countries also have an understanding regarding the exchange of experts and their training but it is time to move beyond it. In the age of CEPA, a mere exchange is simply doing too little. The issue of cooperation in IT was raised both during the visit by the Korean President Lee Myung-bak to India in 2010 and the subsequent visit by Indian Prime Minister Mahmoan Singh's to Korea in 2012. Both sides must strengthen policies of official state encouragement for rendering mutual exchange in this subsector both feasible and profitable, and concomitantly bringing huge opportunities for both the countries in this sector. There are several Indian companies such as Tata Consultancy Services (TCS), Wipro and Satyam who are operating in Korea and in a Forum organized by the Indian Embassy; various future opportunities of cooperation in IT areas were explored. As described in the previous section, it is one of the fastest growing services in India and tapping it would be very significant for bilateral economic cooperation between Korea and India. IT and ITeS account for less than 4 percent of Indian total exports in 1998 but it grew to 24 percent of total Indian exports in 2012. It now constitutes around 7.5 percent of India's total GDP. During his visit to India, Pres. Lee Myung-bak emphasized the need for firm connections between India's IT sector and Korea. He also mentioned increased collaboration in the area of mobile-WiMAX, the latest in wireless broadband internet technology.

As for the banking and insurance subsectors, there is very little exchange between India and Korea. This subsector is important in that it facilitates investment, other financial services and exchange between the two countries. Before signing of the CEPA, only Shinhan Bank was operating in India but there are reports that Woori Bank (opened a branch in Chennai in April 2012), Hana Bank, Bank of Korea and Korea Development Bank are also planning to establish branches in India. According to the provision of the CEPA, Korean banks can open up to 10 branches in India after securing approval from Indian regulating authorities until 2013. The Indian Overseas Bank is the only Indian bank operating

in Korea so far, but hopefully there would be more Indian banks which would be able to connect both countries. The banking sectors of Korea and India would need to reach out to each other to facilitate economic exchange between the two countries in general and cooperation in the services sector in particular. In 2006-07, Korean company Mirae Asset entered the Indian market and the company has been able to garner around 10 percent market share in terms of industry net equity inflows in 2012. Korea's insurance industry also needs to look into the Indian market as the per capita insurance density in India is still \$54.3, which is quite lower than the world average of \$595.1

In several other subsectors of services, cooperation between the two countries could be very positive. Infrastructure is an area into which India needs huge investment. According to one estimate, it requires around \$1.3 trillion investment in next ten years in Indian roads, rail tracks, airports and ports. Korea appears to be interested in this opportunity and Korea Land Corporation (KLC) has been working to set up an industrial park and technology zone along with a multi-product industrial economic zone in Gujarat. Similarly, there are estimates that the demand of travel and tourism in India would grow by 8.2 percent between 2010 and 2019, which would require an investment of \$94.5 billion over the period. The travel industry presents yet another area of opportunity for Korea. Similarly, the healthcare industry in India, which is growing by the rate 23 percent annually, also needs \$14.4 billion by 2025, another good opportunity for foreign investors. The aviation industry in India might also be an attractive magnet for Korean companies, as 100 percent FDI (up to 74 percent automatic route) has recently been allowed, and there is a need of around \$110 billion in investments. Audio-visual and entertainment sector of India also allows for 100 percent foreign investment, especially in areas of film production, television software production, exhibition/distribution and other related areas. India is also the third largest TV market in the world and according to one estimate; it earns an annual revenue of more \$9 billion. Apart from tapping business opportunities and economic benefits, the exchanges in this subsector of services connect people of two countries.

To have further cooperation in the services sector, it would also be essential to connect people of both countries. It is positive that movies, TV dramas and other cultural products of both India and Korea have been trying to attract the attention of people in both countries. In 2010, an Indian film festival was hosted in Korea, which would bring many Indian artists to Korea and connect people. It would make people working in each other country comfortable as there are around 9000 Koreans working in India as well as 7000 Indians living in Korea.

FDI from South Korea

Several policy measures from Indian government would help Korean businesses invest in India. Recently, FDI was allowed in construction as well in the airline industries, which saw an increase of up to 49 percent. From 2003, a Joint Investment Promotion Committee between Korea and India has been working to facilitate these investment proposals. Korean investment in automobile and consumer goods sector has been remarkable and in 2003, cumulative Korean FDI approval was USD 2.65 billion, making Korea the 5th largest investor in India.

With the signing of CEPA, more Korean investment would reach India on reduced tariff rates and India could be utilized by various Korean initiatives as a ‘launching pad’ to facilitate their exports to other parts of the world. The main sectors attracting FDI from Korea are the transportation industry (around one third), fuels (power and refinery), computer software and electronics, chemicals and commercial, office and household equipments.

Table11. Total Korean FDI in India

(Unit: \$ billions)

Industry	Number of New Overseas Enterprises	Accepted Amount	Invested Amount
Total	606	3.346	2.307
Manufacturing (84%)	352	2.801	1.931
Construction	43	0.58	0.043
Wholesale and retail trade (7%)	66	229	0.173
Financial and insurance activities (4%)	4	126	0.083
Others	141	132	0.077

Source: EXIM Bank Korea.

Concluding Remarks

The growth trajectory of the Indian services sector looks impressive and it is very likely that it would continue to perform satisfactorily in future. But in the process, it would be important to bring in more if India's human resources into the sector and make it more wide-based phenomenon. Similarly, there must be coordinated and determined efforts for greater liberalization to the sector and attract more FDI. In the wake of the global economic slowdown, it would be important to resolve difficult issues pertaining to the growth of this sector. However, since the unrealized potentials of this sector are huge, there is high probability of sustained growth in this sector.

The paper also underlines that past experience of Indian-Korea economic cooperation has been largely based on their bilateral cooperation in the non-services sectors. There are exceptional complementarities between the economies of two countries, which have generated spectacular economic synergy between them. However, it would be pertinent to explore, establish and sustain bilateral economic cooperation in the services sector also, as the sector constitutes the most important

sector of economic activities in the world. For the same, both public and private sectors need to explore new areas of cooperation in a more futuristic way. Recent conclusion of CEPA between the two countries is an important step in the right direction, which would be beneficial for both of them. Hopefully in the context of provisions of the CEPA, both countries would be able to establish suitable regimes, institution and policies to realize most of the potential from cooperation in the services sector as well as other sectors of their economies.

The Impact of the Internationalization of the Renminbi on Asian Economies

Lee-Rong Wang¹⁾

I. Introduction

The shock of the 2008 financial tsunami did not stall the progress of the internationalization of the renminbi. It is obvious that the Chinese authorities are treating this as a long-term issue. The recent national debt crises in Europe, which threatened the prospects of the Euro, has made this issue even more attractive for both China and global society than before.

There are basically three stages in the internationalization of the renminbi: first, developing the renminbi as a vehicle currency in international trading, second, facilitating investment tools denominated in renminbi, and third, promoting the renminbi as an international reserve currency. How these evolutions regarding the internationalization of the renminbi affect Asian economies is an interesting and important topic for the region.

1) Lee-Rong Wang is a research fellow at the Chung-Hua Institution for Economic Research (CIER), Taiwan, R.O.C. Lee-Rong Wang has majored in international finance and macroeconomics.

The Chinese authorities started to promote the renminbi as a vehicle currency for the border trades between China and Hong Kong/Macao, as well as between China and ASEAN countries. Due to the large amount of trade between China and these economies, the impact of the internationalization of the renminbi will emerge first in these economies. In fact, the process of the renminbi internationalization in HK/Macao is already at the second stage, i.e., facilitating investment tools denominated in renminbi. For example, Hong Kong has established her significant and leading position as a renminbi offshore center and has striven to issue various financial products with authorization and support of the Chinese government. The ultimate goal of the internationalization of the renminbi is to expedite the renminbi as a dominant international reserve currency.

The purpose of this study is to evaluate the impact of the internationalization of the renminbi, which will proceed via studying some concrete elements during the above-mentioned stages. These elements include the change in the value of the renminbi, the stability of the renminbi, financial activities in China for Asian economies, the competition in developing renminbi offshore centers, the trade and investment of Asian economies in China, and the inclusion of the renminbi in the foreign exchange reserves of Asian countries.

II. Body

(1) Recent Developments for Some Elements Related to the Internationalization of the Renminbi

(1-1) The international currency status of the renminbi

The limited role of emerging market (EM) currencies in international

transactions stands in sharp contrast to the growing weight attached to them in the global economy. While China has become the second largest economy in the world, the international currency status of her currency, the renminbi, still lags far behind that of other large economies²⁾.

Money serves three functions: it is a medium of exchange, a unit of account, and a store of value. International money performs the same role. An added dimension is provided by the distinction between private behavior and the decisions of central banks³⁾. Thus there are six roles of an international currency, which are presented schematically in Table 1. The currency is used as a medium of exchange in private transactions, or a “vehicle,” and is also bought and sold by central banks, thus making it an “intervention” currency. Trade contracts are sometimes denominated in an international currency, making it an “invoice” currency, and the par values for exchange rates are sometimes stated in terms of an international currency, which makes it a “peg.” Finally, private agents hold liquid international currency-denominated assets - the “investment” role - and central banks hold international currency as a reserve. In this section, related statistics and/or figures with regard to these roles are provided to examine the internationalization of the renminbi.

From exploring these roles, it is found that only a few currencies are truly global. Indeed, at present only four currencies are recognized by the International Monetary Fund (IMF) as freely usable globally (i.e., widely used internationally and widely traded in the principal exchange markets). These are the U.S. dollar, euro, British pound, and the Japanese yen. The score board below⁴⁾ (see Table 2) summarizes the prospects of key EM currencies and

2) Among the various studies regarding the degree of the internationalization of the renminbi, Yai Lee (2003), Thimann (2009), and Wu, Pang and Wang (2010) though putting forth different measuring indicators, all conclude that the degree of internationalization of the renminbi is low.

3) Krugman, Paul (1984), "The International Role of the Dollar: Theory and Prospect," in John F. O. Bilson and Richard C. Marston eds., *Exchange Rate Theory and Practice*, Chicago: University of Chicago Press.

4) IMF (2011).

Table 1. Roles of an International Currency

Role	Private	Official
Medium of Exchange	Vehicle Currency	Intervention Currency
Unit of Account	Invoice Currency	Pegging Currency
Store of Value	Investment Currency	Reserves Currency

Source: Kenen (1983); Krugman (1984); McKinnon (1993); and Hartmann and Issing (2002).

draws comparisons with the issuers of international currencies.

To sum up, economic influence, trade flows and centrality tend to support the potential of a subset of EMs, particularly China, to have their currencies internationalized. In particular, increasing trade linkages among EMs could encourage a south-south use of EM currencies. However, each economy has a different structure and may face different challenges. EM countries have made progress in deepening their financial markets, with China and Brazil standing out for rapid expansion of their domestic bond markets. However, their potential for use in trade settlement may be limited by the structure of their trade and reliance on commodity exports. Arguably, the renminbi has the greatest potential to become internationalized, provided financial sector reforms and capital account liberalization continue.

Table 2. International Currency Status: A Score Board

	USD	Euro	Yen	Pound	SWF	AUD
AE currencies						
Widely used as international reserves	●	●	●	●	●	○
Widely used in capital and trade payments	●	●	●	●	○	○
Widely traded in FX markets	●	●	●	●	●	●
Economic size	●	●	●	●	●	●
Trade network	●	●	●	●	●	●
Investability 2/	●	●	●	●	●	●
Capital account openness 3/	●	●	●	●	●	●
Financial depth index 4/	●	●	●	●	●	●
EM and NIE currencies						
Widely used as international reserves	○	○	○	○	○	○
Widely used in capital and trade payments	○	○	○	○	○	○
Widely traded in FX markets	●	●	●	○	○	○
Economic size	○	●	○	●	●	●
Trade network	●	●	●	●	●	●
Investability 2/	●	●	●	●	●	●
Capital account openness 3/	●	●	●	○	●	○
Financial depth index 4/	●	●	●	●	●	●

1/●●" criteria fully met; ●"partially met; ○"not met.

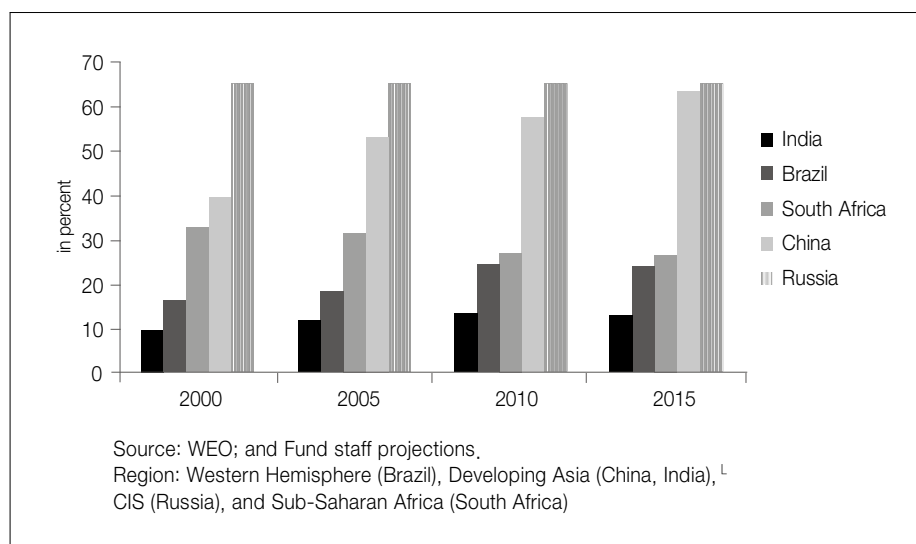
2/ "●" Based on sovereign risk ratings "A" or above by Moody's and S&P.

3/ Based on Chinn and Ito "Capital Account Openness Indicator, 2008"

4/ Country contributions to global financial depth, "●" for top five contributors.

Source: IMF (2011).

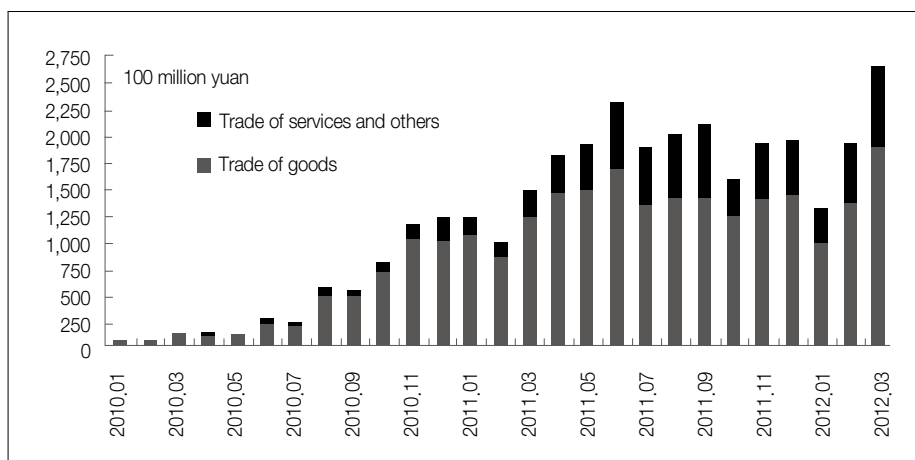
Figure 1. Regional Share of Trade Flows, 2000-15



China's regional importance has grown markedly in the last 10 years (see Figure 1). This is particularly significant considering that interregional trade in Asia has accounted for a large part of the growth in global trade in the last decade.

China has made the most progress in promoting the cross-border use of the renminbi, in particular since the start of the pilot scheme in early 2010, suggesting that rapid change in the actual use of international currencies is quite possible (see Figure 2). The growing accumulation of renminbi deposits offshore has accompanied the rapid pace of renminbi trade settlement and has spurred the development of renminbi financial instruments offshore. In August 2011, the renminbi trade settlement was extended nationwide, and renminbi-denominated FDI and portfolio flows (within set quotas) were authorized from the Hong Kong SAR to the mainland, thus significantly expanding investment channels for the renminbi offshore, and constituting an

Figure 2. Renminbi Settlement for Cross Border Trade

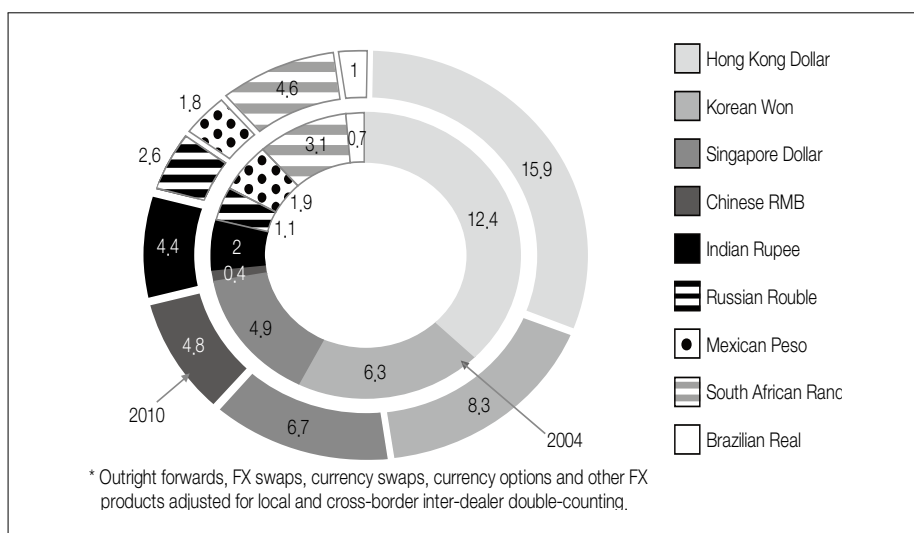


Source: PBC.

important step toward wider currency use. Renminbi settlement of cross-border direct investments reached 49.87 billion yuan in the first three months of 2012, including 2.87 billion yuan of outbound direct investments and 47 billion yuan in foreign direct investment. The renminbi settlement share within global transactions amounted to 0.16% in 2010.

The U.S. dollar and euro are the two most widely-used currencies in international trade (Goldberg and Tille, 2008) and capital transactions. While EM currency use remains small, bilateral efforts are underway by country authorities to promote their wider use in trade settlement and capital transactions. Accordingly, there have been steady gains in the use of EM currencies, such as the renminbi and the Brazilian real. The share of the use of the renminbi increased from almost nil in 2004 to 5.8% in 2010 in international bond issuance (see Figure 3).

Figure 3. International Bond Issuance in Emerging Market Currencies
(Percentage of Total Emerging Market Issuance)*

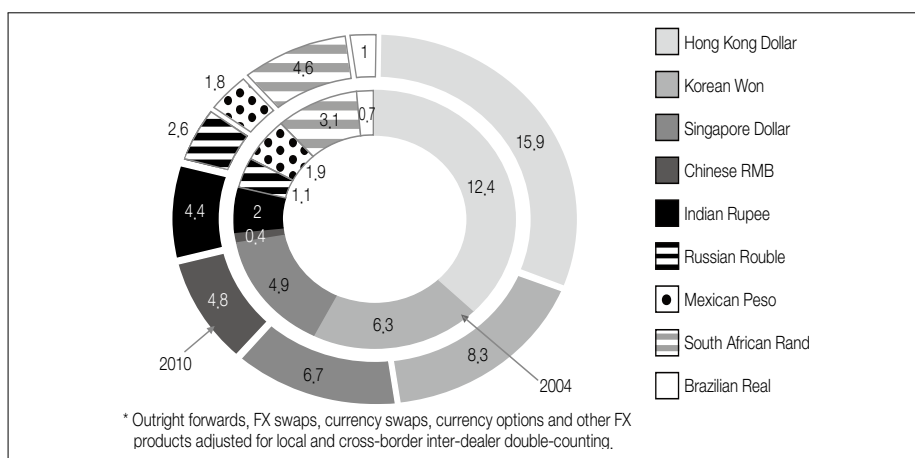


Source: BIS(2010. 12), *Quarterly Review*.

As of 2010, the four currencies in the SDR basket (U.S. dollar, euro, British pound, and Japanese yen) comprised about 75 percent of global foreign exchange turnover amid the increased trading of other currencies. The currencies of Asian financial centers, such as the Hong Kong dollar and Singapore dollar, are also frequently traded, but the use of these currencies is limited. Other EM currencies, such as the Chinese renminbi, while being traded in progressively greater amounts, remain insignificant in the global FX market.

Moreover, the lack of hedging instruments is a major impediment to more international use of EM currencies, as reflected in the small trading volumes of FX derivatives (see Figure 4). In 2010, the Chinese renminbi accounted for only 4.8%.

Figure 4. Emerging Market currencies- OTC Foreign Exchange Derivatives Turnover (Share Percentage out of 200 Percent)*



Source: BIS(2010. 12), *Quarterly Review*.

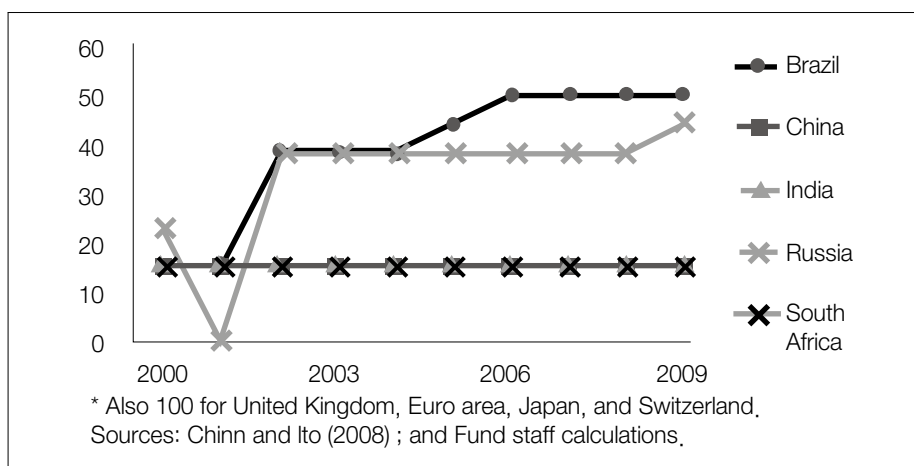
(1-2) The convertibility of the renminbi

As mentioned above, the renminbi has the greatest potential to become internationalized among emerging market currencies, provided that financial sector reforms and capital account liberalization continue in China.

According to the statistical data of the IMF, it takes between seven and ten years on average from the time that a country deregulates its current account to when it deregulates its financial account. In the case of China, sixteen years have passed since she liberalized her current account in 1996. The reason for the difficulty that China faces in setting a time schedule for her deregulation is that China is too big and faces various complicated problems, such as the pressure of economic growth, cross border flows of hot money, and pressure from western countries caused by trade protectionism⁵⁾. The deregulation/convertibility of the financial account is thus a very difficult

5) Shen and Wang (2012).

Figure 5. Capital Account Openness Index Relative to United States, US=100*



issue for China to deal with. In this case, the degree of the capital account openness of China is less than that of some other EMs, such as Brazil and Russia (see Figure 5).

However, a report promulgated in February 2012 by the People's Bank of China has pointed out that the necessary conditions for China to speed up the deregulation of her financial account have essentially already been fulfilled. The report suggests that the deregulation of China's financial account involves three stages (see Table 3).

From this report, it can be concluded that financial sector reforms and capital account liberalization will continue in China, although at a cautious pace.

(1-3) The development of renminbi offshore centers and China's onshore financial markets

Various measures have been taken to facilitate the sound development of China's domestic financial markets and to deepen the reform of China's

Table 3. Three Stages of the Deregulation of the Financial Account in China

Stage	Realized Time	Contents of Deregulation	Type	Reasons for Deregulation
Short term	In 1-3 years	Liberalizing the regulations on direct investment with real trading base	FDI	Direct investment is more stable, and affected less by economic fluctuations. It has been proved that deregulating direct investment involves the least risk.
Mid term	In 3-5 years	Liberalizing the regulations on commercial credit with real trading base	FOI	Commercial credit with real trading base is closely related to the current account and is more stable, with less risk.
Long Term	In 5-10 years	After enhancing the construction of the financial market, liberalizing the capital inflow and then capital outflow, liberalizing the real estate market, followed by the stock and bond markets.	FPI	It is hard to distinguish the investment demand and speculative demand in real estate, stock and bond markets. Thus, the liberalization will be based on the soundness of the markets.

Source: Revision based on Shen and Wang (2012).

financial institutions. For instance, the market-based interest rate reform and the reform of the renminbi exchange-rate regime were enhanced in both directions. The market-based interest rate reform will expedite the competition among the financial institutions in China, especially China's state-owned banks, which reaped huge profits under the government's guarantee of the spread between the loans and the deposits. Foreign financial institutions which are accustomed to the competition in doing business under flexible interest rates will benefit from this reform. This will of course increase the degree of the internationalization of China's onshore financial markets.

For the purposes of enlarging the cross-border use of the renminbi, regulating the relevant business of renminbi loans of China's domestic banks for overseas projects, mitigating risk, and promoting trade and investment facilitation, some guidelines have recently been formulated by the Chinese

government. Overseas projects refer to the various overseas investments and other cooperation projects launched by China's domestic institutions in the process of "going global". Banks shall, according to the relevant provisions on renminbi bank settlement accounts and payment and settlement management, provide fund transfer and other relevant services for cross-border renminbi loans directed toward field projects.

In particular, renminbi settlement of cross-border trade and investment has grown considerably. In the first quarter of 2012, renminbi settlement of cross-border trade was 580.4 billion yuan, representing a growth of 61 percent year on year. This included 416.57 billion yuan in trade in goods, and 163.83 billion yuan in exports of services and other items under the current account. Actual renminbi receipts and payments in the first quarter totaled 550.01 billion yuan, bringing the receipts-to-payments ratio from 1:1.7 in 2011 to 1:1.4, suggesting a more balanced use of the renminbi in settling imports and exports. On June 5, 2012, the PBC, jointly with other related government units, issued the Letter on the Focused-supervision List of Enterprises That Conduct RMB Settlement for Merchandise Exports⁶⁾. By then, all enterprises that have export licenses can conduct renminbi settlement for merchandise exports according to the law.

(2) The Impact of the Internationalization of the Renminbi

(2-1) The impact of the change in the value of the renminbi and the stability of the renminbi on Asian economies is not great

During the process of the internationalization of the renminbi, the value of the renminbi has to remain strong, on the one hand, to attract other countries to maintain an interest in the renminbi and, on the other hand, to change the

6) PBC General Administration Department Document [2012] No. 381.

way in which China's economic growth is brought about. That is to say, to reduce the share of the exports in China's GDP, as claimed in China's Twelfth Five-Year Plan, the value of the renminbi cannot be kept weak. To summarize, from a long-term perspective, a strong renminbi is expected if China is to maintain a relatively high economic growth rate. This will lead to relatively strong expectations on the regional currencies in Asia.

However, for the time being, under the pressure of the global economic stagnation triggered by the ongoing European national debt crisis, the Chinese authorities are not willing to let the value of the renminbi become too strong so as to hurt China's exports. The impact of the change in the value of the renminbi on Asian economies is thus not great.

The PBC has sought to improve the reform of the renminbi exchange-rate regime in line with the principle of making it a self-initiated, controllable, and gradual process. By focusing on the role of market supply and demand, the PBC has enhanced renminbi exchange-rate resilience with reference to a basket of currencies and has kept the renminbi exchange rate basically stable at an adaptive and equilibrium level. In the first quarter of 2012, the central parity of the renminbi against the US dollar peaked at 6.2840 yuan per dollar and reached a trough of 6.3359 yuan per dollar. It appreciated on 29 out of the 58 trading days in the first three months, and depreciated on the other 29 trading days.

Effective April 16, 2012, the renminbi exchange rate against the US dollar has been allowed to float in a wider band in the interbank spot foreign exchange market, from the previous 0.5 percent to 1 percent around central parity. PBC operations in the foreign exchange market, while becoming less frequent, have accordingly been reoriented to moderating excess exchange-rate volatility. Exchange-rate fluctuations in the interbank market have strengthened since the floating range was expanded, thereby enhancing the market's capacity to seek an equilibrium level, while the foreign exchange market has generally remained stable. In this case, in considering the incentive for central banks

to hold a more stable reserve currency asset, greater fluctuation in the renminbi will probably reduce the willingness of central banks to hold renminbi. However, if the renminbi remains stable with the moderation of the PBC, the impact on the holding will then be minimized.

(2-2) Financial activities in China are increasing for Asian economies

The financial activities of some of China's neighboring economies in China are increasing, which will help speed up the internationalization of the renminbi. In this subsection, several instances are cited from different financial areas to clarify the current development in this regard.

First of all, in the foreign exchange, the Malaysian Ringgit and Russian Rouble were listed in the Swift system in China, becoming the seventh and eighth currencies to be traded within the system nowadays. On May 29, 2012, with the authorization of the PBC, the China Foreign Exchange Trade System (CFETS) announced its intention to improve the trading mode between the renminbi and the Japanese Yen (CNY/JPY) and to launch direct trading between the two currencies, to take effect on June 1, 2012.

Secondly, the participation in China's inter-bank bond and stock markets through the QFII arrangement⁷⁾ for the Asian economies has also been enhanced recently. For instance, the applications by the Korea Investment Corporation (KIC) and some public institutes related to pension funds were approved by the China Securities Regulatory Commission (CSRC) for them to become QFIIs in March 2012. In addition, the renminbi clearing bank and other eligible institutions outside China were allowed to invest in the interbank bond market in China in August 2010.

7) QFII denotes "Qualified Financial Institutional Investor," which refers to a foreign investor who participates in a local financial market indirectly. This kind of indirect procedure is often adopted by countries during their initial stages of liberalizing local financial markets.

Table 4. Bilateral Currency Swap Agreements between China and Other Countries

Sq.	Signing Date	Counterpart country	Amount (unit: billion RMB)
1	12/12/08	Korea	180
2	01/20/09	Hong Kong (the first signature)	200
3	02/08/09	Malaysia (the first signature)	80
4	03/11/09	Belarus	20
5	03/23/09	Indonesia	100
6	04/02/09	Argentina	70
7	06/10/10	Iceland	3.5
8	07/23/10	Singapore	150
9	04/18/11	New Zealand	25
10	04/19/11	Uzbekistan	0.7
11	05/06/11	Mongolia (the first signature)	5
12	06/13/11	Kazakhstan	7
13	11/22/11	Hong Kong (the second signature)	400
14	12/22/11	Thailand	70
15	12/23/11	Pakistan	10
16	01/17/12	United Arab Emirates	35
17	02/08/12	Malaysia (the second signature)	180
18	02/21/12	Turkey	10
19	03/20/12	Mongolia (the second signature)	10
20	03/22/12	Australia	200
Total			1,756.2

Note: 1. In November 2011, China signed the second currency swap agreement with Hong Kong, which replaced the first one signed in 2009.

2. In February 2012, China signed the second currency swap agreement with Malaysia, which replaced the first one signed in 2008.

3. In March 2012, China signed the second currency swap agreement with Mongolia, with the swap amount being enlarged from 5 billion RMB to 10 billion RMB.

Source: Revision based on Shen and Wang (2012).

Thirdly, around seventeen countries signed the bilateral currency swap agreements with China between December 2008 and March 2012, with total amounts of up to RMB 1756.2 billion (see Table 4). For instance, the Bank of Korea and PBC signed an agreement in September 2009 to extend the scale of the bilateral currency swap, from 180 billion RMB to 360 billion RMB, between the two countries. The above-mentioned bilateral currency swap agreements have different motives to an earlier currency swap agreement, the Chiang Mai Initiative, that was signed in 1999 by the ASEAN plus three (China, Japan, and Korea). The purpose of the Chiang Mai Initiative is to provide financing on foreign currencies while liquidity shortages in foreign currencies occur and to avoid the reoccurrence of a regional currency crisis, whereas the bilateral agreements between China and various countries are intended to facilitate the currency settlements related to bilateral trade and investment.

(2-3) The competition to develop renminbi offshore financial centers is very strong among certain Asian Economies

In this subsection, the advantages and disadvantages on developing a renminbi offshore center are compared among some Asian economies⁸⁾ (see Table 6).

(2-3-1) Hong Kong

Hong Kong has the foremost advantage in terms of the capital pool and settlement amount of RMB, so far a complete RMB settlement system has been established. However, it used to be a settlement center instead of a trading center based on foreign exchange. And it is passive because of the overdependence on China.

8) Wang (2012).

The development of offshore renminbi business in Hong Kong, beginning with the initiation of personal renminbi business, can be traced back to January 2004 (see Table 5). Various measures, for example, the issue of renminbi bonds in July 2007, the commencement and the extension of the pilot scheme for renminbi trade settlement since July 2009, and the arrangement of foreign enterprises to conduct and settle foreign direct investment into China in renminbi (the so-called RFDI), were followed later. Foreign investors were then allowed to invest in China's bond and equity markets through funds issued by qualified fund management and securities companies in Hong Kong under the Renminbi Qualified Foreign Institutional Investors (RQFII) scheme in December 2011.

As a Special Administrative Region of China, Hong Kong, on the one hand, has a close connection with and is controlled by inland China and, on the other hand, maintains her own unique status with regard to the currency for fifty years (up to 2047). According to the Basic Law, Hong Kong is thus chosen, with the lowest risk, as the first experimental candidate for developing the offshore renminbi business. We believe that, with the ongoing support from China, Hong Kong will maintain her leading role in this regard.

(2-3-2) Singapore

Singapore also has established a complete RMB settlement system. While under comparison with Hong Kong, it has overlapping time zone and less close to China. The trading amount between Singapore and China is only one-fifth of that between Hong Kong and China. However, Singapore has a closer trading relationship with Southeast Asia than Hong Kong. Thus, Singapore is more likely to become a renminbi offshore center in Southeast Asia. The inter-Asia regional trading share for Singapore is about 55%, but the share for Hong Kong is only around 20%. Singapore has complete foreign exchange products. Also it has a flexible market system and government policy. From purely considering the market, Singapore as an existing foreign exchange trading center is more likely to become a renminbi offshore center within a decade.

(2-3-3) Japan/Tokyo

Japan was the fourth largest trading partner of China in 2011 and has been the second largest source of inward foreign direct investment in China for years. Tokyo is the biggest foreign exchange trading center in the Asia-Pacific area. Direct trading between the renminbi and the Japanese Yen (CNY/JPY) has just been launched. However, Tokyo is lagging behind, compared with Hong Kong, on getting started as a renminbi offshore center. The other disadvantage for Tokyo is that it is too domestic market-oriented and has a declining share within the world economy.

(2-3-4) Taiwan/Taipei

The close economic relationship across the Taiwan Strait is the biggest advantage that Taiwan has in developing a renminbi offshore business. Taiwan was the seventh largest trading partner of China in 2012 and has been the second or third largest source of inward foreign direct investment in China for years. Same with Singapore and Hong Kong, Taipei has a complete RMB settlement system, but their time zones are overlapping. In addition, Taipei's performance as a financial center is ranked behind that of other centers in the region. Looking forward, however, various deregulations beneficial to Taipei's financial development, such as Offshore Security Unit and Free Economic Pilot Zones, are expedited. In particular, deregulations in the bond market, including removing the requirement of credit rating on issuing bonds and applying different regulatory measures on professional and non-professional investors on renminbi-denominated bonds, will be carried out soon.

Table 5. Development of Offshore Renminbi Business in Hong Kong

January 2004	Personal renminbi business commenced.
July 2007	The launch of the first issue of renminbi bonds in Hong Kong.
July 2009	The pilot scheme for renminbi trade settlement commenced operations.
September 2009	The first renminbi sovereign bond by the Ministry of Finance of China.
February 2010	The Hong Kong Monetary Authority issued a circular to elucidate the supervisory principles and the operational arrangements regarding the cross-border fund flows of renminbi and the development of renminbi business in Hong Kong.
June 2010	The geographical coverage of the pilot scheme for renminbi trade settlement was expanded.
July 2010	The Clearing Agreement for renminbi business was amended to facilitate the development of renminbi asset management and insurance products.
August 2010	Announcement of a pilot scheme for the renminbi clearing bank and other eligible institutions outside Mainland China to invest in the interbank bond market in Mainland China.
November 2010	Renminbi sovereign bonds issued through the Central Moneymarkets Unit.
December 2010	The number of eligible enterprises in Mainland China that can settle merchandise exports in renminbi increased from 365 to 67,359.
January 2011	Enterprises in Mainland China were allowed to conduct and settle overseas direct investment in renminbi, and banks in Hong Kong could provide renminbi funds to facilitate such transactions.
August 2011	The geographical coverage of the pilot scheme for renminbi trade settlement was further expanded to the whole of Mainland China.
October 2011	Arrangements for foreign enterprises to conduct and settle foreign direct investment in Mainland China in renminbi were formalized.
December 2011	Foreign investors were allowed to invest in Mainland China's bond and equity markets through funds issued by qualified fund management and securities companies in Hong Kong under the Renminbi Qualified Foreign Institutional Investors (RQFII) scheme.
March 2012	All enterprises in Mainland China can settle their trade in renminbi.

Source: "Hong Kong The Premier Offshore Rimininbi Business Center," Hong Kong Monetary Authority, April 4, 2012.

Table 6. The Comparison of the Advantages and Disadvantages on Developing a Renminbi Offshore Center for Some Asian Economies

City	Advantages	Disadvantages
Hong Kong	<ol style="list-style-type: none"> 1. Has the foremost advantage in terms of the capital pool and settlement amount of RMB so far 2. A complete RMB settlement system has been established 3. Close connection with the rest of China 4. Having a cluster effect on RMB trading with Shanghai 	<ol style="list-style-type: none"> 1. Used to be a settlement center based on trade, rather than a trading center based on foreign exchange 2. Is passive due to depending too much on China
Singapore	<ol style="list-style-type: none"> 1. Has complete foreign exchange products 2. Has a flexible market system and government policy 3. A complete RMB settlement system has been established 	<ol style="list-style-type: none"> 1. Overlapping time zone with Hong Kong 2. Less close to China, compared with Hong Kong
Tokyo	<ol style="list-style-type: none"> 1. Is the biggest foreign exchange trading center in Asia-Pacific area 2. Direct trading between the RMB and the Japanese Yen (CNY/JPY) has just been launched. Is supported by the PBC for Japanese enterprises to issue RMB bonds in Tokyo and in other overseas markets 	<ol style="list-style-type: none"> 1. Lags behind in terms of getting started 2. Is too focused on the domestic market and with a descending share within the world economy
Taipei	<ol style="list-style-type: none"> 1. Has a close economic relationship with China 2. A complete RMB settlement system has been established 3. Various deregulations are expedited 	<ol style="list-style-type: none"> 1. Taipei's performance as a financial center is ranked behind that of other centers in the region 2. Overlapping time zone with Hong Kong
Seoul	<ol style="list-style-type: none"> 1. performance as a financial center is progressing 2. Chinese enterprises will be attracted to invest in Korea to avoid the threat of being accused of dumping their exports, with the signing of the U.S.-Korea FTA and the EU - Korea FTA 	<ol style="list-style-type: none"> 1. Lags behind in terms of getting started

Source: Revision based on Wang (2012).

(2-3-5) Korea/Seoul

Though its performance as a financial center is progressing, it lags behind in terms of getting started. But for Chinese enterprises, to avoid the threat of being accused of dumping their exports, they will be attracted to invest in Korea with the signing of the U.S.-Korea FTA and the EU-Korea FTA. These FTAs, together with the one that will probably be signed in the future by China, Japan, and Korea, are all of benefit to the development of a renminbi offshore center in Seoul. Korea was the sixth largest trading partner of China in 2012 and has been the sixth largest source of inward foreign direct investment in China for years.

(2-4) Possible impacts on the trade and investment of Asian Economies

Generally speaking, since the internationalization of renminbi will facilitate currency settlements between China and other economies, it is definitely helpful in increasing the bilateral trades, investments, and financial activities between China and various economies. In addition, with the launching of renminbi settlement between China and other Asian economies, the influence of the internationalization of the renminbi on bilateral trade and investments will emerge in first place in these economies.

As shown in Table 7, during 2009 and 2011, among major Asian countries, only Japan, Taiwan, Korea, Malaysia, and Thailand recorded a trade surplus with China. This means that if renminbi settlement is to be operated for much of the trading deals between these countries and China, these countries are likely to build up their holdings of renminbi very quickly. If the Chinese government does not want the renminbi to flow within these countries, other things being equal, a more rapid entry of direct investments or portfolio investments by these countries in China will probably be allowed. If the Chinese government is concerned about leaving renminbi in these countries, other things being equal, it will be good for these countries to develop their

offshore renminbi business with abundant amounts of renminbi accumulated via their trade surpluses. In the latter case, the Chinese banks located in these countries will also benefit as they engage in renminbi-related business.

By contrast, most ASEAN countries, which maintain trade deficits with China, probably need more renminbi financing, regardless of whether they obtain this by borrowing from Chinese banks or through currency swaps, and so on. In addition, for those countries holding a trade surplus with China, the speed of their renminbi settlement on trade will be higher than those countries with trade deficits vis-à-vis China. The reason is that renminbi is more likely to appreciate than depreciate over the next decade, given China's higher economic growth prospects and sounder fiscal condition relative to most large economies. Therefore, surplus countries will have more of an incentive to engage in renminbi settlement trading.

As the degree of internationalization of the renminbi increases, it will become easier for foreign investors to remit their profits earned in China. This will probably change some investment behavior as well. For instance, it will become less necessary for the foreign investors to take their orders from the home countries. This will then negatively affect the export figures of those home countries.

Table 7. The Total Trade, Export, and Net Trade of China with Respect to Some Asian Economies

Year	The percentage of total trade (%)			The percentage of total exports (%)			The percentage of total imports (%)			Trade surplus Unit: 100 million USD		
	2009	2010	2011 (Jan-Nov)	2009	2010	2011 (Jan-Nov)	2009	2010	2011 (Jan-Nov)	2009	2010	2011 (Jan-Nov)
Japan	10.37	10.02	9.43	8.15	7.67	7.8	10.2	9.92	9.36	-47	-173	-139
Taiwan	4.81	4.89	4.43	1.71	1.88	1.88	3.92	4.36	4.76	-189	-312	-432
Indonesia	1.29	1.44	1.65	1.23	1.39	1.54	1.2	1.07	1.27	27	71	64
Singapore	2.17	1.92	1.75	2.5	2.05	1.89	1.36	1.49	1.32	164	115	117
Korea	7.08	6.97	6.79	4.47	4.36	4.44	7.7	7.32	6.95	-237	-332	-338
Vietnam	0.95	1.01	1.08	1.36	1.46	1.49	0.47	0.5	0.63	116	161	159
Philippines	0.93	0.93	0.88	0.71	0.73	0.75	0.51	0.46	0.49	35	50	51
Malaysia	2.35	2.5	2.47	1.63	1.51	1.45	2.81	2.73	3.04	-87	-143	-232
Thailand	1.73	1.78	1.8	1.11	1.25	1.36	1.77	1.77	1.6	-45	-50	-20

Source: The General Administration of the Customs of China.

Table 8. The Inward Foreign Direct Investment of China from Asian Economies

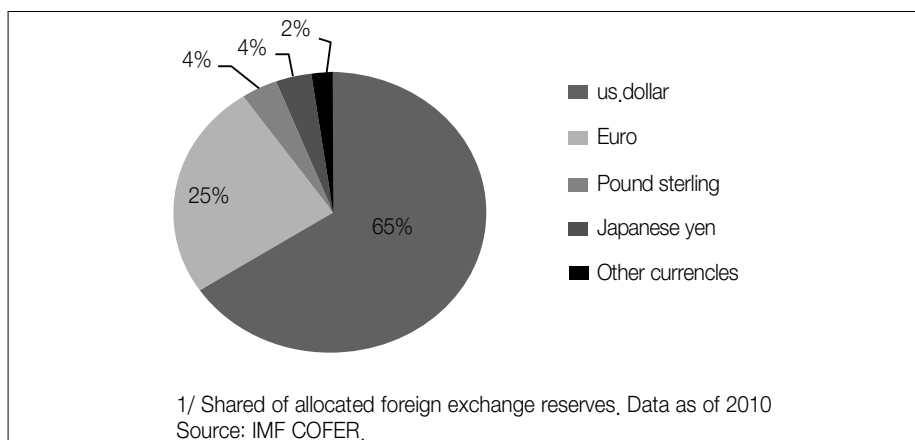
Year	2009		2010		2011 (Jan-Nov)	
	Total Amount	Percentage (%)	Total Amount	Percentage (%)	Total Amount	Percentage (%)
	900.33	100.00	1,057	100.00	1,037.69	100.00
Hong Kong	539.93	59.97	674.74	63.81	683.52	65.87
Taiwan	65.63	7.29	67.01	6.34	62.45	6.02
Japan	41.17	4.57	42.42	4.01	59.38	5.72
Singapore	38.86	4.32	56.57	5.35	52.94	5.10
USA	35.76	3.97	40.52	3.83	27.39	2.64
Korea	27.03	3.00	26.93	2.55	23.36	2.25

Source: Department of Foreign Investment Administration, Ministry of Commerce, People's Republic of China.

(2-5) The inclusion of the renminbi into the foreign exchange reserves of Asian economies will become prevalent

With the internationalization of the renminbi since 2009, the attitude of the PBC with regard to promoting the inclusion of the renminbi into the composition of the special drawing rights (SDRs) has changed from aggressive requests to conservative claims (Phone Cheng 2011). This is due to the PBC's finding that the core issue for China's national interest is China's voting rights in the IMF, i.e., China's share of the holding of SDRs, rather than whether or not the pricing of SDRs is related to the renminbi. It is noted that the inclusion of the renminbi in the composition of the SDR has something to do with the pricing of SDRs and has nothing to do with China's SDR holdings. The elements affecting China's holding are China's export share and ***. It is thus proposed that the target for China in the IMF is to steadily propel the internationalization of the renminbi according to China's own needs and interests.

Figure 6. Currency Composition of Official Foreign Exchange Reserves (Average 2001-10, 1)

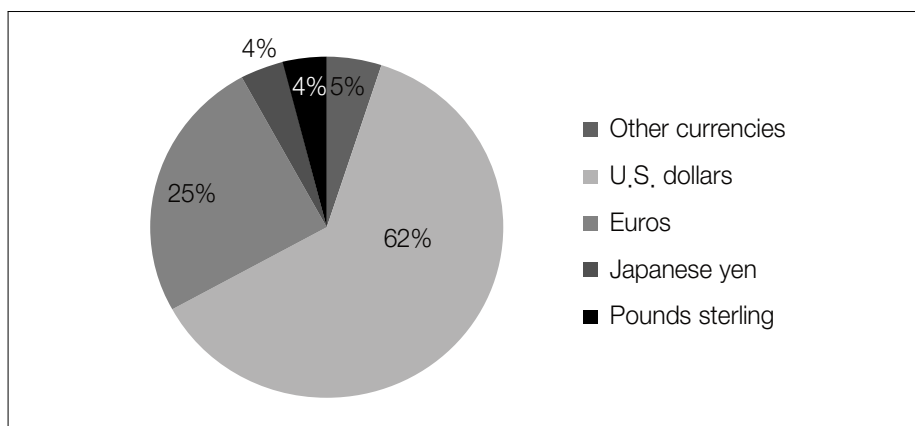


The IMF's rules regarding the change in the programming of the basket currency is discussed every five years. Since the IMF report regarding weighing change was only recently published in 2010, the new technical condition will not be carried out until 2015. After that, it will take five more years for the renminbi to be introduced formally into the basket.

As for the share of the renminbi in the foreign exchange reserves of other economies, the data published by the IMF do not decompose the currencies under the category of "other currencies", as shown in Figure 6 and 7, and thus it is difficult to resolve this issue. However, it is said in general that the renminbi accounts for around 1%~2% of total official foreign exchange reserves. The share of foreign exchange reserves under the category of "other currencies" in the first quarter of 2012 was 5%, which was higher than the average of 2.2% from 2001 to 2010.

With the increasing potential of the internationalization of the renminbi, the close economic relationship with China, and the long-term expectation of a stronger renminbi, there is no doubt that the inclusion of the renminbi into the foreign exchange reserve of Asian economies will become prevalent in the future.

Figure 7. Currency Composition of Official Foreign Exchange Reserves (2012Q1)



Source: IMF COFER.

III. Conclusions

The purpose of this study is to evaluate the impact of the internationalization of the renminbi. The evaluation proceeds by studying some concrete elements during the stages of the internationalization of the renminbi. These elements include the change in the value of the renminbi, the stability of the renminbi, financial activities in China for Asian economies, the competition in developing renminbi offshore centers, the trade and investment of Asian economies in China, and the inclusion of the renminbi in the foreign exchange reserves of Asian countries.

This paper first examines the international currency status of the renminbi. While China has become the second largest economy in the world, the international currency status of her currency the renminbi, however, still lags far behind that of other large economies. Economic influence, trade flows and centrality, among various measuring indicators, tend to support the potential of China to have her currency internationalized. Arguably, the renminbi has

the greatest potential to become internationalized among some of the major currencies in emerging markets, provided that financial sector reforms and capital account liberalization continue.

The conclusions of the evaluation are as follows:

(1) The impact of the change in the value of the renminbi and the stability of the renminbi from the perspective of Asian economies is less than significant. During the process of internationalizing the renminbi, the value of the renminbi has to be kept strong to attract other countries' interest in holding renminbi. From a long-term point of view, a strong renminbi is expected if China continues to maintain a relatively high economic growth rate. This will lead to relatively strong expectations for a regional currency in Asia. However, under the pressure of global economic stagnation caused by the worsening European national debt crisis, the Chinese authorities cannot allow the value of the renminbi to become too strong in a way that would hurt China's exports. The impact of the change in the value of the renminbi on Asian economies is thus not great. As to the stability of the renminbi, although the fluctuation band has been expanded, the moderation exercised by the PBC will result in the impact being smaller than expected.

(2) The financial activities of some of China's neighboring economies are increasing, which will help speed up the internationalization of the renminbi. For instance, the Malaysian Ringgit and Russian Rouble were listed in the Swift system in China, becoming the seventh and eighth currencies to be currently traded within the system. In addition, around seventeen countries signed bilateral currency swap agreements with China from December 2008 to March 2012, with the purpose of facilitating the currency settlements related to bilateral trade and investment.

(3) The competition to develop renminbi offshore financial centers has become quite intense among some Asian economies. The advantages and disadvantages of several economies/cities, including Hong Kong, Singapore, Tokyo, Taipei, and Seoul, are explored. Hong Kong has become the premier renminbi offshore center with the support of Chinese authorities. With a closer trading relationship with Southeast Asia than Hong Kong, Singapore is more likely to become a renminbi offshore center in Southeast Asia. Taiwan just signed a MOU on Currency Settlement Cooperation across the Strait with China, which significantly raises her potential for developing a renminbi offshore business. The FTAs signed with the EU and the USA, respectively, and the one that will probably be signed in the future by China, Japan, and Korea, are all of benefit to Seoul in terms of developing a renminbi offshore center.

(4) There are some impacts on the trade and investment of Asian economies. For those countries holding a trade surplus with China, the speed of their renminbi settlement on trade will be higher than for those countries with trade deficit vis-à-vis China. As the renminbi becomes more internationalized, it will become easier for foreign investors to remit their profits earned in China. This will probably change some investment behavior as well. For instance, it will become less necessary for foreign investors to take orders from their home countries, which will negatively affect the export figures of those home countries.

(5) As for the share of the renminbi in the foreign exchange reserves of other economies, since the data published by the IMF do not decompose the currencies under the category of “other currencies”, it is difficult to determine what the shares for each currency are. However, it is said in general that the renminbi accounts for around 1%~2% of total official foreign exchange reserves. The share of foreign exchange reserves under the category of “other

currencies” in the first quarter of 2012 is 5%, which is higher than that of the average of 2001 to 2010, or 2.2%. With the increasing potential for internationalization of the renminbi, the close economic relationship with China, and the long-term expectation of a stronger renminbi, there is no doubt that the inclusion of the renminbi into the foreign exchange reserves of Asian economies will become more prevalent in the future.

References

- BIS. 2010. “Derivatives in Emerging Markets.” *BIS Quarterly Review*. (December)
- Chinn, Menzie D., Barry Eichengreen, and Hiro Ito. 2011. “A Forensic Analysis of Global Imbalances.” La Follette School Working Paper 2011–007.
- Goldberg, Linda S., and Cédric Tille. 2008. “Vehicle Currency Use in International Trade.” *Journal of International Economics*, Vol. 76, No. 2, pp. 177–92.
- IMF. 2011. “Internationalization of Emerging Market Currencies: A Balance between Risks and Rewards.” Prepared by Samar Maziad, Pascal Farahmand, Shengzu Wang, Stephanie Segal, and Faisal Ahmed, under the direction of Isabelle Mateos y Lago and Udaibir Das, Strategy, Policy, and Review Department and Capital markets Department, *IMF Staff Discussion Note*, SDN/11/17. (October 19)
- Kenen, Peter B. 1983. *The Role of the Dollar as an International Currency*. New York: Group of Thirty.
- Krugman, Paul. 1984. “The International Role of the Dollar: Theory and Prospect.” John F. O. Bilson and Richard C. Marston eds. *Exchange Rate Theory and Practice*. Chicago: University of Chicago Press.
- Lee, Yiau. 2003. “Non International Currency, Currency Internationalization, and The Convertibility of Capital Account.” (in Chinese). *Research on Finance*, No. 8.

- McKinnon, Ronald I. 1993. "The Rules of the Game: International Money in Historical Perspective." *Journal of Economic Literature*, 31(1).
- Shen, Chung-Hua and Lee-Rong Wang. 2012. *The Internationalization of Renminbi, Currency Settlement Mechanism, and Taiwan* (in Chinese). Reports on Research Series, Taiwan Academy of Banking and Finance, August 2012.
- Thimann, Christian. 2009. "Global Roles of Currencies." European Central Bank Working Paper, No. 1031.
- Wang, Lee-Ron. 2012. "The Exploration on the Feasibility of Taiwan's Developing Renminbi Offshore Center and Policy Suggestions." (in Chinese) *Research Project carried out on behalf of the Taiwan Academy of Banking and Finance*. (January)
- Wu, Friedrich, Rongfang Pan, Di Wang. 2010. "Renminbi's Potential to Become a Global Currency." *China & World Economy*, 18(1).

Comparative Research on Automotive Industry Policies between South Korea and China

Fu Baozong¹⁾

I . Introduction

Both in China and Korea, the governments have played a strong role in the development of the automobile industry. There are some similarities in the automotive industrial policies between China and Korea, but at the same time, there are significant differences in the said policies between the two countries, such as in policies on foreign investment, technical innovation, exports, development of the passenger car and so on. To a certain extent, it is political differences between the two countries that explain the different competitiveness of the automobile industries in the two countries in terms of firm scale and industry concentration, ability of independent research and development, automobile exports, internationalization of automobile manufacturers and so on. Comparative research on automotive industry policies between South Korea and China would provide

1) Dr Fu Baozong now works as a research associate in the Academy of Macroeconomic Research, National Development & Reform Commission of the PRC.

us with some meaningful implications including: Effective market competition can be a powerful driving force to improve the competitiveness of the auto industry, encouragement of independent R&D is the key to improving the competitiveness of the auto industry, and internationalization of management is a phase that both countries must go through in order to improve the competitiveness of the auto industry.

Given the state of initial backwardness in the auto industry, in order to catch up with the developed countries, both China and South Korea chose a government-led development of their auto industry. Pushed by policies and market mechanisms, auto industries of the two countries grew rapidly and have now become important global powers in automobile production and consumption. But, due to different social systems and other factors, the auto industry policies in South Korea and China were different in some ways, especially in technological policy, organization policy and so on. Differences in automobile industry policy led, directly and indirectly, to a huge gap in competitiveness of automobile industry between the two countries.

II . Comparison of China and Korea's Development of Automobile Industry

The automobile industries in China and Korea were started within ten years of each other. In 1944 and 1953, Korea and China respectively founded their first automobile enterprise; in 1955 and 1956, China and Korea respectively produced their first automobile. By 2011, China's auto production reached 18.419 million units, ranking the largest automobile-producing country in the world; Korea produced 4.658 million automobiles, which made it the 5th largest automobile-producing country in the world. China's automobile industry has experienced three stages of development from its inception to the present, which were stages of “independent development, joint venture development and mixed

Table 1. Comparison of the Development of Automobile Industry Between China and Korea

Year	China	Korea
1944	—	The first automobile enterprise named Kyungsung Precision Industry was set up, which was later became KIA Motors.
1953	The first automotive enterprise, known as First Automobile Workshop(FAW) was created.	—
1955	—	The first automobile named "Sibal" was born, which was assembled using an American jeep.
1956	The first truck named Jiefang was produced by the First Automobile Workshop.	—
1958	In May, the first passenger car (Dongfeng brand) produced by the First Automobile Workshop; in August, the first car named Red Flag (hongqi) was manufactured.	—
1962	—	The first truck (K-360) first manufactured by KIA motor company.
1967	Construction of second automobile factory known as Second Automobile Works begins.	Hyundai Motor Company was established
1974	—	The first passenger car (BRISA B-1000) produced in KIA motor company
1980	Auto production reaches 223,000 units	Auto production reached 123,000 units
1988	Auto production reaches 645,000 units	Auto production exceeds 1 million units, reaching 1,084,000 units
1992	Auto production exceeded 1 million units, reaching 1,067,000 units	Auto production reaches 1,730,000 units
1993	Auto production reaches 1,299,000 units	Auto production exceeds 2 million units
2000	Auto production exceeds 2 million units, reaching 2,070,000 units	Auto production reaches 3,110,000 units
2002	China's auto production exceeds Korea once again, reaching 3,250,000 units	Auto production reaches 3,140,000 units
2011	Auto production reaches 18,419,000 units, the largest one in the world	Auto production reaches 4,658,000 units, the 5th largest one in the world

Figure 1. Auto Production in China and Korea(1995-2011)



development.” On the other hand, the Korea auto industry has experienced four stages of development including: "joint venture development, independent development, export development, and international development. Overall, currently the Korean automobile industry is more internationalized than China's auto industry.

2.1 Development of the automobile industry in China

(1) 19571-1980: Independent Development Phase

This phase is characterized by planning and closed market. Firstly, the establishment, production, and sales of automotive manufacturers were directly controlled by the central government, and all auto manufacturers were state-owned. In October 1949, the central government began working on development of automobile industry for a new China, which marked the beginning of China's auto industry. In March 1951, the central government approved the construction of the first automotive enterprise of China named First Automobile Workshop (FAW)

in Changchun. In June 1953, constructions for the First Automobile Workshop began. In December 1965, the government decided to set up a Preparatory Bureau for the second automobile plant. In April 1967, work on the second automobile plant named Second Automobile Works officially broke ground. Secondly, automobile technology of the time mainly relied on independent research and development. In July 1956, the first Chinese truck, named Jiefang, was produced by the First Automobile Workshop, which was the first domestically-produced automobile in China. In May 1958, the first passenger car (Dongfeng brand) was born in the First Automobile Works, and in August the first of the Red Flag models was manufactured, which is being produced and are on sale in the market even today. Thirdly, trucks were the mainstay among all automobiles produced in China. At the beginning of the reform and opening in the 1980s, China's auto production reached 222,000 units, but only including 5400 cars.

(2) 1980-2000: Joint Venture Development Phase

This phase was characterized by marketization and joint ventures. Firstly, the auto companies were given more and more operational autonomy as time went on. Since the reform and opening, the marketization of the automobile industry has been accelerating. On May 7, 1982, the China Automotive Industry Corporation was officially established in Beijing. Since then, the State made efforts to change the regulatory model for the auto industry. In 1983, the government began to make an important marketing attempt, that is to say, the auto makers could sell some automobiles by themselves. Afterwards, automobile enterprises played an increasing role in operation and development of the automobile industry. Secondly, the wave of Sino-foreign joint ventures gradually rose in the automobile industry. In order to introduce more advanced international technology and management knowhow, China adopted a "market for technology" model of development, therefore the joint ventures continued to increase. On January 15, 1984, the first automotive joint venture named Beijing Jeep Corporation was founded by the

Beijing Automotive Company and a US auto company, and the opening ceremony was held. Since then, most domestic automobile manufacturers such as FAW, SAIC have set up joint ventures with international auto giants, and joint ventures in the automotive sector, particularly in the area of passenger cars, gradually became predominant in China's automobile market.

(3) 2000-present: Mixed-development Phase

This phase was characterized by outbreaks of domestic auto market and mixed competition in the market. Firstly, as cars began to enter the lives of Chinese families, the domestic auto market of China grew rapidly. From 2000 to 2011, the volume of sales of automobiles in the domestic market increased from 2.07 million units to 18.42 million, so China became the world's largest country in terms of automobile production and sales. Secondly, there was increased attention toward independent R&D and independent brand of automobile. Domestic auto enterprises started to enhance the international competitiveness of their brand of cars by independent research and mastering core technologies based on introduction and absorption of advanced foreign technology and management knowhow. Thirdly, some Chinese automobile companies began to enter the international market. In recent years, some domestic automobile companies, especially the domestic brands, began to pay more attention to automobile exports. What is more, some companies tried to actively invest overseas and became more internationalized.

2.2 The development of the automotive industry in Korea

Although Korea starting to produce automobiles in the 1950s, its auto industry really began in the early 1960s, when the government started to attach importance to the development of the automobile industry. At that time the automobile manufacturers began to produce automobiles by assembling imported parts and components from some developed countries.

Overall, the Korean automobile industry has experienced four stages of development:

(1) Joint Venture Stage

Firstly, at this stage, the development of domestic auto companies was directly supported by the government. In April 1962, the Government issued “the Korean Automobile Industry Development Plan”, which tried to take the scattered automotive companies under management of the government; in 1962, “the Automobile Industry Protection Act” was issued, which was the formal declaration by Korea about the development of the automotive industry. Since then, encouraged by the preferential policies, Korea went on to establish several new automobile companies such as Asia, Hyundai and so on, which mostly cooperated with foreign automobile companies from the United States, Italy or other countries. Secondly, most auto companies produced assembly cars with foreign technology. In the early years, most of Korean automobile enterprises relied on foreign technology, that is to say, Korean automobile companies usually assembled the automobiles with imported semi-finished products and components.

(2) Localization Stage

In December 1969, Korea issued the “Automotive Industry Development Plan”, proposing the objectives of localization of passenger cars in 1972 and the objectives of localization of buses in 1974. From 1972, “the Third Five-year Economic Development Plan (1972~1976)” was also focused on consolidation and development of the automotive industry. In this stage, the Korean automobile companies made efforts to develop domestic cars, designing their own vehicles and models. In 1974, Hyundai Motor Company produced exclusively self-designed cars, so Korea became the 16th country in the world with an independent capacity for producing cars.

(3) From late 1970s to mid-1980s: Export Stage

As the automobile manufacturing developed rapidly, the Korean government began to guide the auto companies to improve their technology, expand the scale of production, and then export to international markets. In 1979, the Korean government officially announced automobiles as one of Korea's top ten exported goods. By 1986, Korea exported 292,000 motor vehicles accounting for 1.9% of world exports. Korea became the 9th largest automobile exporter in the world.

(4) From mid-1980s to early 1990s: International Development Stage

Firstly, the support policies for the automobile industry were phased out. Since 1987, the Korean government gradually abolished a number of preferential policies for nurturing and protecting the automotive industry. Secondly, the domestic automobile market became more open than before. In order to encourage competition among auto companies, production of vehicles and designing of models by automobile companies was no longer be restricted, which helped to promote the development of automobile industry to a higher level. In this context, most of Korean auto companies continued to upgrade their international competitiveness. At present, Korean cars have been exported to more than 190 countries and regions of the world.

In recent years, the automobile industry has played an important role in the economic development both in China and Korea. At present, the share of employment and output of the Chinese auto industry in the manufacturing sector stands at 2.2% and 4.3% respectively; the share of employment and output of the Korean auto industry in the manufacturing sector is at 10.2% and 10.1% respectively.

Table 2. Relative Position of the Automobile Industries in Chinese and Korean Economies

	Classification	Employment	Production	Added Value
China	Auto Industry ('10) (Thousand persons, 100million Yuan)	2134.3	7561.5	6759.7
	Share of Manufacturing Industry	2.2%	4.3%	4.2%
Korea	Auto Industry ('09) (Thousand persons, trillion won)	250	113	35
	Share of Manufacturing Industry	10.2%	10.1%	9.4%

III. Similarities in Automobile Industry Policies of China and Korea

3.1 Government Support

In China.

The government of China adopted a policy of active support to the automotive industry initially. Firstly, the auto industry was taken as a pillar industry of the country. The Chinese government consistently increased importance placed on the auto industry. This is made clear in the “seventh five-year plan” which states: “Automobile manufacturing is a pillar industry of the state.” In 1990 and in 1993 the central government declared the auto industry as a key industry. Secondly, the government imposed a strict qualification system on the auto industry and supported several key automobile enterprises directly. In August 1987, the State Council decided to support the production in three automobile companies including First Automobile Workshop (FAW), Second Automobile Works (SAW) and Shanghai Automotive Industry Corporation (SAIC). In 1988, the State Council issued “the circular on strict controls on car production”, which was clearly the layout of “three big and three small” strategy, namely, only the three big automobile companies (FAW, SAW, SAIC) and three small automobile companies (in Tianjin, Guangzhou and Beijing) would be supported. Aside for those already approved by the State Council, new car production would be restricted for other companies.

In 1989, the “decision of the State Council on current industry policy points” designated automobiles as products where any production by the companies not approved by the state by severely restricted. Thirdly, there was the strict management of automotive products. The government also made strict controls on automobile products. On May 6, 1989, the state promulgated “the provisional rules directory of automobiles”, as a basis for managing automotive products.

In Korea

The Korean government has also promulgated a series of policies and measures to strongly support the automobile industry. Firstly, a series of development plans on the auto industry has been introduced by the government. In February 1979, the Korean Ministry of Commerce and Industry clearly took the automobile industry as one of its top ten strategic industries. In 1962, the Korean government launched “a five-year plan for the automobile industry” and in 1964 the Korean government issued “a comprehensive promotion plan for the automobile industry.” In 1965, the government unveiled the “three-year automobile localization plan.” In 1969, “Basic Plan for Automobile Industry Promotion” was issued. In 1974, another “auto industry development plan” was issued. Secondly, the government developed a series of standards for the automobile industry to promote the development of the industry. In 1967, “Automobile Plant Permission Standards” was published; In 1975, for the systematic development of small and medium-sized auto makers, the government enacted the “Systematization Promotion Act,” the objectives of which was localization, which tried to reorganize a number of small and medium enterprises into competitive enterprises engaged in development and specialization of auto parts, while consolidating some other auto companies to become larger groups.

Table 3. China's Tariffs and Consumption Tax on Imported Cars (2002-2004)

Exhaust volume(L)	Consumption tax	Tariff			Comprehensive tax		
		2004	2003	2002	2004	2003	2002
<2.2	5%	34.20%	38.20%	43.80%	65.28%	70.20%	77.11%
2.2-3.0	8%	34.20%	38.20%	43.80%	70.67%	75.76%	82.86%
>3.0	8%	37.60%	43.00%	50.70%	75.00%	81.85%	91.65%

3.2 Protecting the Domestic Market

At the beginning of development of the automobile industry, in order to support their respective domestic automobile industries, both China and Korea took more stringent measures including tariffs and non-tariff barriers to protect the domestic automobile market.

In China

Firstly, the imported cars have been facing higher tariff rates for the past several decades. From 1951 to 1984, the tariff rates on imported cars were 60%. From 1985 to 1993, for increased protection of the domestic auto market, the automobile import tariff rates were increased to 100%-120%. From 1994 to 2001, the automobile import tariffs were falling gradually in the context of overall decrease in national tariffs. In 2002 when China entered the WTO, the automobile import tariff rates were slashed to 43.8%-50.7%, and then in 2006 continued to fall to 25%, while the tariffs on auto parts was down to 13%.

Secondly, in addition to tariffs, China has also set up many non-tariff barriers to protect its market, such as import management, import plans, foreign exchange controls, foreign trade rights approval and the classification of imported commodity and so on. At the same time there were a series of quantitative restrictions on imported automobiles such as quotas, license control and so on. Since the Reform and Opening up, China has experienced four stages of management on imported

automobiles: (1) from 1978 to 1993: the stage of strict internal approval for imported automobiles. That is to say, no automobile could be imported unless the plans of the imports had been approved by the government in advance; (2) from 1994 to 2001: the stage of internal approval was institutionally placed under the total quantitative control by government. That is say, quotas for imported automobiles were issued and the demand of imported automobiles must be approved by the related institutes of the central government. (3) From 2002 to 2004: according to related rules of WTO, the government of China annually announced to the organization the quota volume of imported automobiles, the related program and required materials to get the quotas approved and so on. (4) From 2005 to present: the stage of full openness according to the related rules of WTO. On January 1, 2005, the quotas for imported automobile were abolished. Since then, the times of quantitative management of automobile imports ended in China and China has become one of the most open automobile markets in the world.

In Korea

In order to support the domestic auto industry, the Korean government has also taken a series of strict protection measures for the domestic market for a long time. Since the “Automobile Industry Protection Act” was enacted in 1962, automobile imports were banned for about 20 years. The Korean domestic auto market was not open until 1986. From 1986 to 1995, the tariff rates on imported autos in Korea declined from 60% to 8%. But at the same time, there were still various non-tariff barriers on imported automobiles, such as limits on establishing sales network of imported cars, prohibiting advertisement of imported automobiles on TV or in newspapers, special tax check on customers who purchased foreign limousines, the anti-luxury and “buy Korean” campaign, loan limits to foreign automobiles, limiting quantities that could be imported at one time and so on. On the other hand, since 1989, the Korean government exempted the special consumption tax of “national car” in order to promote their sales.

Table 4. the Restructuring Policies of Chinese Auto Industry in Recent Years

Year	Institutes	Policy	Contents
2004	National Development and Reform Commission (NDRC)	“Automotive Industry Development Policy”	Guiding the reorganization of existing automobile producers. Promoting domestic automobile enterprises to become larger and stronger. Encouraging merging and reorganization of the automobile enterprises in accordance with market rules.
2006	NDRC	“Notice on Structural Adjustment of Automotive industry by NDRC”	Calling for the backbone enterprises to combine and restructure with property rights as a link and for the purpose of economies of scale
2007	NDRC	“The Eleventh Five-year Development Plan of Automotive Industry”	State would expect to develop 1 to 2 large automotive groups capable of producing more than 2 million vehicles a year, a number of key automotive enterprises producing more than 1 million vehicles a year.
2009	The State Council	“The Restructuring and Revitalization Plan for the Auto Industry”	Encouraging mergers among the large auto companies on a national level, such as FAW, Dongfeng, SAIC, Changan, etc; supporting some mergers in a regional context, including Beijing Automotive, Guangzhou Auto, Chery and China National Heavy Duty Truck.

3.3 Industrial Organization Policies

In China

The Government has taken a series of measures to support construction of large-scale automobile enterprise groups, to increase the industrial concentration of automobile industry. In 1994, “Auto Industry Policy” was enacted and one of its main goals was to support the development of key automobile companies and achieve economies of scale in the automobile industry; and at the same time, deciding on favorable policies for large automobile enterprises such as policy loans, tax breaks, and priority to issue stocks or bonds and so on. In 2004, the “Automotive Industry Development Policy” was created once again to encourage the formation of large

enterprise groups by strategic restructuring of existing automobile enterprises. In spite of a series of efforts made by the government, the problem of automobile enterprises in China being generally smaller and industrial concentration lower has not been fundamentally resolved to this day.

In Korea

In 1972, the Korean government began to take measures to close the small and medium-sized assembly automobile plants all over the country, only supporting several major automobile manufacturers such as Hyundai, Asia Motor and so on. In 1980, the Korean government launched the “automotive industry alliance” resolution, helping Hyundai, Daewoo and other major automobile manufacturers to expand rapidly. In 1981, according to the “Provisions of Rationalization of the Automobile Industry,” passenger cars would only be produced in Hyundai Motor Company and Shinhan Automobile Company, and commercial vehicles would be produced only by KIA Motor Company. Since the 1990s, the Korean government has implemented the “big group strategy” in the auto industry. Through restructuring and mergers, the concentration of Korean automobile industry increased significantly. Obviously the industrial policies of automobiles have played an important role on promoting Korean automobile companies to become larger and on enhancing their international competitiveness.

2.4 Promoting Localization of Products and Technology

In China

In order to facilitate the localization of foreign automobile models, the Chinese Government has taken a wide range of policies. Firstly, in the late 1980s, there were rules that localization rate of joint ventures in China shall not be less than 40%, but this provision was canceled after China's accession to the WTO. Secondly,

the tariff rate of imported auto parts was determined according to the localization ratio of related automobiles, that is, the higher the localization rate of automotive products, the lower their rates of tariffs on imported parts, and vice versa. Finally, the government encouraged companies to extract fees from profits of introducing automobiles, for the appropriate technology of automobile parts. At the same time, in order to make the policy implementation easier, the government has also issued the “Administrative Measures of Identification on the Localization of Automobile Products” and other documents.

In Korea

In May 1962, the Korean government enacted the “Automobile Industry Protection Act”, limiting imports of cars and auto parts; only the parts that the domestic auto companies was badly in need of but could not yet produce in Korea could be imported. In 1966, the Korean government established a localization plan. The preferential allocation of foreign exchange was linked to the degree of localization of cars, and the automobile assembly plants was unified with the New Auto Company (the predecessor of Daewoo Motor Company) as the core; on the other hand, the government promoted localization of auto parts in 75 key enterprises. In 1969, the “Plan on Full Localization of Auto Parts” emphasized increasing levels of home-made cars once more, and in 1970, the “Automobile Industry Promotion Programme” provided that all car companies must achieve the goals of localization by late 1974. Because of the series of domestic policies, from 1966 to 1981, the localization rates of automobiles in Korea rose from 21% to 92%.

IV. Differences of Automobile Industry Policies between China and Korea

4.1 Policies of Independent R&D in Auto Industry

In China.

Before the reform and opening up, China developed the automobile technology entirely on its own, but due to a lack of international exchange and cooperation, the progress in China's automotive technology was slow at that time. Since the reform and opening up, China has begun to encourage the development of automobile joint ventures. During this period, policies mostly emphasized introduction of foreign technology through cooperation with transnational corporations; however, for a long period, there was insufficient support toward independent development of automobile technology by national enterprises. Until 2004, the "Auto Industry Policy" proposed that the government would "encourage domestic automobile manufacturing enterprises to improve their capability for independent research and development and technological innovation, actively developing products with independent intellectual property rights and implement the brand management strategies." Even so, policies to support homegrown automobiles are still not systematic, lacking matching measures of operability. Therefore, to combine the introduced technology abroad with homegrown automobiles remained the main methods for the development of automobile technology in China in recent years.

In Korea

The Korean automobile industry has always adhered to the principles of independent development in the past several decades. The Korean government began requiring earlier that auto companies independently develop their own automobiles, while encouraging independent research and development activities

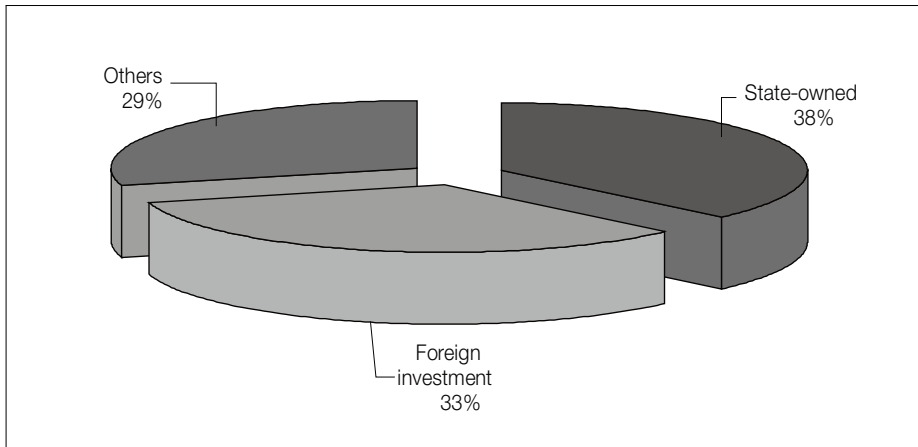
by the domestic automobile companies have been encouraged all along. In 1973, the government required that domestic automakers should independently design their own automobile models, instead of using European vehicle permits. In 1974, the Korean government also issued long-term revitalization plans for the automobile industry, which proposed that by the end of 1975, wholly ‘domestic’ cars would be produced; the Korean automobile companies were to develop a “Korean model” of cars, the exhaust volume of which is below 1.18 liter, and strive to achieve annual output of more than 80,000 units. Under guidance of such policies, Korean auto companies have made efforts to cultivate their capabilities for independent R&D and technological innovation. After a period of hard work, several domestic auto companies in Korea, including Hyundai and others, had achieved basic capability of independent development of cars.

4.2 Policies of Utilizing Foreign Capital

In China

Since the reform and opening up, joint ventures have been dominant in the development of automobile industry in China. In 1984, China’s first auto joint venture, namely the Beijing-Jeep Corporation, was officially established, which was the first SUV joint venture in China. In 1985, the first joint venture in automobiles was set up in China, namely the Shanghai-Volkswagen Automotive Company; from 2002 to 2003, the activities of joint ventures in the Chinese automobile industry were coming to fruition. Most of the world famous automotive multinational companies including those from Germany, the United States, France, Italy, Japan and other countries have established joint ventures with China’s key state-owned auto companies. Those joint ventures generally produce vehicles in China by introducing the foreign automobile models, technology, brands and components, and sell them in the Chinese market. However, the existing domestic brands were neglected to some extent. Furthermore, the domestic private capital

Figure 2. Share of Sales Value of Automobile Manufacturers by Ownership in China (2010)



has been strictly limited in the automobile industry and faced a very high threshold of strict policies while the industry was opened up to foreign investment. Therefore, state-owned firms and joint ventures dominated China's car market, while the share of private capital in China's auto industry has been low. In recent years, the automobile enterprises with private capital and domestic brands developed more rapidly, but they were still at a disadvantage in the market because of inadequate support by policy and a late start. Because of the lack of private capital, vitality and efficiency of China's auto market have been objectively weakened, and therefore the competitiveness of China's auto industry was also weakened.

In Korea

To maintain independent development of the domestic auto industry in Korea, foreign investment has been limited by the government in several ways, including foreign equity restrictions, foreign exchange balance and localization requirements. Only in the late 1990s, only when some of Korea's auto enterprises faced the risk of bankruptcy due to the impacts of the Asian financial crisis, did the Korean

government decide to introduce foreign investment to help domestic enterprises get out of trouble. Even so, Korea's local enterprises continued to actively develop their own automobile technologies. The policies of automobile industry in Korea have played an important role in helping the Korean national automobile enterprises to break free from control of foreign enterprises, thus eventually forming independent and complete system for the automobile industry in Korean. On the other hand, the Korean domestic car companies have completely realized privatization and marketization beforehand, which was important for the automobile industry to keep a high level of operating efficiency.

4.3 Policies on Cars

Because of technology related to cars is more complex than trucks and buses, passenger car manufacturing may better represent the competitiveness of a national auto industry. In the past several decades, China has paid less attention to car industry than Korea, which has affected the overall competitiveness of the Chinese automobile industry.

Since 1958 when the first domestic car was born in China, the national policy has been focused mainly on trucks. Therefore, in the ensuing decades, development of the Chinese car industry has been very slow. Prior to reform and opening up, there were only several types of domestically-developed cars in China like the Red Flag, Beijing, Shanghai and so on, with the style unchanged for decades. By 1980, passenger car production was only 5,400 units in China, which only accounted for 2.4 percent of the nation's total automobile production. In 1994, the Chinese government developed a policy on the automotive industry, which initially encouraged and supported purchase of vehicles by private citizens. On October 11, 2000, "the CPC Central Committee on the formulation of the tenth five-year plan for national economic and social development" presented the recommendations: To encourage entry of passenger cars into ordinary households,

to devote major efforts to developing public transportation. It was the first time that the topic of encouraging introduction of passenger cars into ordinary households was included in the national development planning. As of May 10, 2001, the guide management on the car prices was canceled. Private auto purchases have greatly released the potential of China's car market. Since then, the market demand led China's rapid growth in passenger car production and the share of passenger car production in total automobiles production also increased rapidly. In 2011, 10.14 million cars were produced in China, accounting for 55 percent of the total production of automobiles.

In Korea

The Korean government attached great importance to the development of the auto industry at the beginning, and also began developing the domestic market for cars earlier than China; all of these factors helped Korean automobile companies to seize the initiative in the development of the automobile industry in time. In 1987, in order to promote the popularity of cars, the Korean government proposed a concept of "national cars," which provided reduction of special consumption tax and other preferential policies for 'economy' cars. Since 1989, the Korean government decided to waive the special consumption tax on "national cars" in order to promote their sales. Supported by those policies, passenger cars entered households in Korea much earlier than in China. At present, the proportion of passenger cars in total production has reached 90.6% in Korea, far higher than in China. To emphasize the research and development of cars by the government has helped Korean automobile enterprises to study and master the most advanced technologies and management experiences for passenger cars much earlier.

Table 5. Auto Production by Type in China and Korea (2011)

	(Units)				
	Total	Passenger Cars	Trucks	Buses	Others
Korea	4,657,094	4,221,617	276,156	145,300	14,021
Share of total	100.0%	90.6%	5.9%	3.1%	0.3%
China	18418876	14485326	2653747	398347	881456
Share of total	100.0%	78.6%	14.4%	2.2%	4.8%

4.4 Export policies.

In China

The Chinese government has only recently to devote greater attention to encouraging automotive exports, much later than the Korean government. In China, the automobile joint ventures aimed at selling their products in the domestic market are usually not interested in automobile exports; however, the international competitiveness of domestic own-brand enterprises are still weaker, so it would take a long time for them to expand their automobile exports. In 2004, the “Auto Industry Policy” at first proposed that the government would “actively support the national automobile brands, and promote exports to overseas markets.” As of July 1, 2007, in order to encourage exports, the government issued a policy of substantial tax refund for export goods, including 14 types of auto parts and several motorcycles. Especially, the national vehicle exports would be given tax rebates of up to 17%. In addition, the government also issued policies to support the export bases of national automobile and auto parts, regulate the orders for exports, and also imposed license management on the automobile products including passenger cars, commercial vehicles, and chassis and so on. Affected by above policies, China's auto exports began to grow in recent years, though still far less than Korea's.

In Korea

In the 1970s, the Korean government began to implement export strategies in earnest. In 1974, the Korea government issued the "long-term car industry revitalization plan" which proposed specific export targets for the near future. In 1977, the government designated the automotive industry as a strategic export industry. At the same time, the government developed "comprehensive policies of revitalization of export", introducing a series of preferential measures on export industries, including foreign exchange loans, equipment financing, assistance of technology transfer, and so on. In addition, the government also provided to exporters raw materials in case of shortages, low interest loans or long-term concessional loans and gave export subsidies to major automobile manufacturers. Above policies have played an important role in promoting the Korean automobile enterprises to expand their exports.

V. Comparison on Results of Automobile Industry Policies between China and Korea.

Partly because of differences between the policies on automobile industry of China than from that of Korea in some respects, the auto industry in Korea currently and obviously have greater international competitiveness than China's.

5.1 Scale of the Automobile Company and Industry Concentration

China lacks large international enterprises with international influence and Chinese automobile enterprises are generally smaller. Therefore, auto industry concentration in China is much lower than in Korea.

Table 6. the Automobile Sales of Top 5 Auto Companies in China and in the World (2011)

Ranks	World		China	
	Auto Companies	Sales (1000units)	Auto Companies	Sales (1000units)
1	General Motors	9030	Shanghai Automotive Industry Corporation (SAIC)	3966
2	Volkswagen	8160	Dongfeng Motor	3058.6
3	Toyota Motor	7950	First Automobile Workshop(FAW)	2601.4
4	the Renault Nissan Alliance	7390	Changan Automobile Company	2008.5
5	Hyundai Motor	6590	Beijing automotive Company	1526.3

In China

For many years, in order to enhance concentration in the automobile industry, the Chinese government has taken a series of the administrative and economic measures. However, due to some unreasonable institutional mechanisms, the effects of those policies were unsatisfying. In recent years, driven by rapid growth in domestic automobile demand, many local governments tried to support investment in the automobile industry, and domestic automakers grew rapidly as a result. However, while China has more than 100 automobile manufacturers now, each manufacturers produces less than 200,000 units of automobiles on average. Korea has only 7 auto manufacturers, but each manufacturer produces 600,000 units on average. The production of the top 5 auto manufacturers in China reaches only 71.5 per cent of total production, and of the top 10 reaches only 87 percent of the total production.

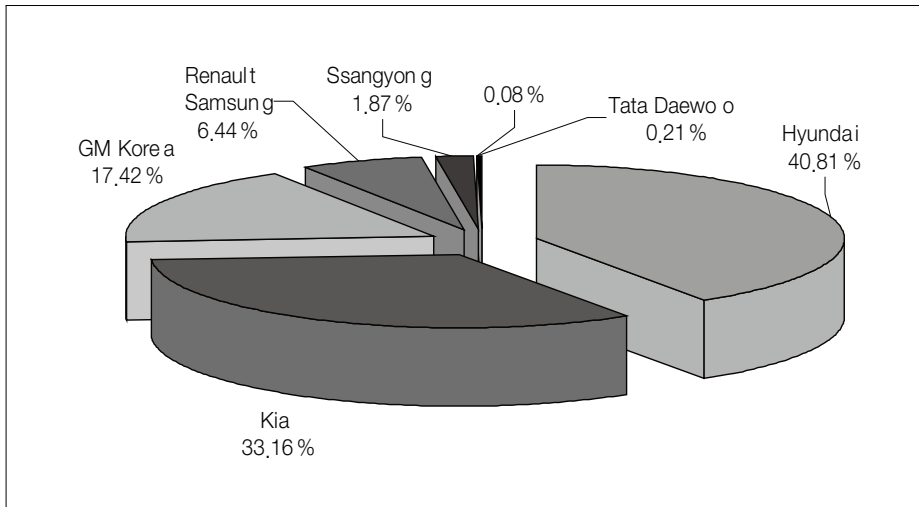
Table 7. Revenues and Profits of the Automobile Companies in Top 500 in the World (2011)

Ranks in auto industry	Ranks in the world	Auto Companies	Revenues (million dollars)	Profits (million dollars)	Nation
1	8	Toyota Motor	221760.2	4765.7	Japan
2	13	Volkswagen	168041	9052.7	German
3	20	General Motors	135592	6172	USA
4	24	Daimler	129480.6	5957.4	German
5	25	Ford Motor	128954	6561	USA
6	45	Honda Motor	104342.1	6235.7	Japan
7	48	Nissan Motor	102430	3727.1	Japan
8	55	Hyundai Motor	97408.4	4707.6	Korea
9	79	BMW	80099.4	4262.1	German
10	90	Peugeot	74250.6	1501.9	France
11	145	Dongfeng Motor	55748.2	2479.7	China
12	151	SAIC	54257.2	1914	China
13	163	Renault	51615.6	4529.7	France
14	197	China Faw Group	43434.4	2125.5	China
15	226	China South Industries Group	37996.4	224.7	China

In Korea

In contrast, the auto industry concentration in Korea is much higher than in China. According to statistics by Korea Automobile Manufacturers Association (KAMA), there are now only 7 independent auto manufacturers in Korea at present, of which only 5 manufacturers can produce passenger cars; namely Hyundai, Kia, Renault Samsung, GM Korea and Ssangyong.

Figure 3. Share of Automobile Production by Makers in Korea (2010)

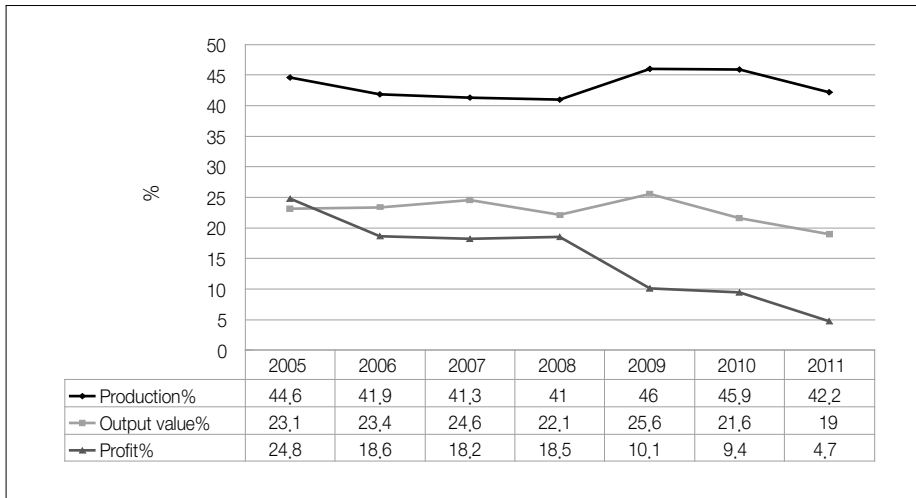


5.2 Ability of Independent R&D

In China

At present, the foreign brands of joint ventures occupy a dominant position in China's domestic automobile market. However, joint ventures in China generally lack the foundation of proprietary technology and therefore do not have full abilities for automobile research and development. The major auto companies generally lack of initiative in development and selection of new automobile products. Moreover, in terms of technological development of automobile parts, Chinese car companies lag far behind the international advanced level, and a number of key parts and components still cannot be independently designed and produced. By 2010, there were 14 enterprises that could produce their own brand of cars in China, producing over 60 car models. However, the independent auto brands are mostly lower-end products with a price of less than 100,000 Chinese Yuan. In 2011, 6.11 million units of domestic brand passenger cars were sold in China,

Figure 4. Share of Own Brand of Passenger Cars in China



accounting for 42 percent of total passenger car sales. It is worth noting that due to the lower added value, the own-brand cars are weaker in profitability. In 2011, the profits achieved by own-brand passenger cars only accounted for 4.7% of the total profits of domestic passenger cars.

In Korea

In the late 1970s, under the guidance of the principle of “independent development, independent production and independent management,” independent development capacities of major auto companies in Korea began to increase. From the beginning of 1980s, in order to develop their own cars, Korean motor companies have trained a great number of automobile researchers and established several institutes for automobile research and development. In 1986, the research and development expenses of Hyundai and Daewoo reached about 4 percent of their sales value, close to the advanced international level. Major automakers in Korea have since developed independently a variety of auto models, including the body,

chassis, engines and other parts. Currently, the domestic brand automobiles in Korea account for over 90% of domestic sales. It is more important that Korean auto brands are making an increasing influence on the international market.

5.3 Export Ability

In China

In 2001, China's auto exports were less than 20,000 units. Since then, the automobile exports of China began to grow. From 2002 to 2007, the export of Chinese automobiles rose from 20,000 to 613,000 units. From 2008 to 2009, affected by the international financial crisis, China's automobile exports declined rapidly. In 2009, China exported only 370,000 automobiles, equivalent to 2006. By 2010, encouraged by a series of support policies, the automobile exports improved again. From 2011, China's auto exports have rebounded rapidly. In 2011, China exported 814,000 vehicles, of which nearly one-third were passenger cars. However, to this day China's vehicle exports are still dominated by low-end products. Export markets for Chinese autos are mainly concentrated in the developing countries, such as South-East Asia, Africa and the Middle East, and even fewer are exported to the developed countries like the European Union and the United States. In contrast, auto exports of China account for a lower proportion of auto production than of Korea and of many other countries. In 2011, China exported only 4.4 percent of the total production of automobiles.

In Korea.

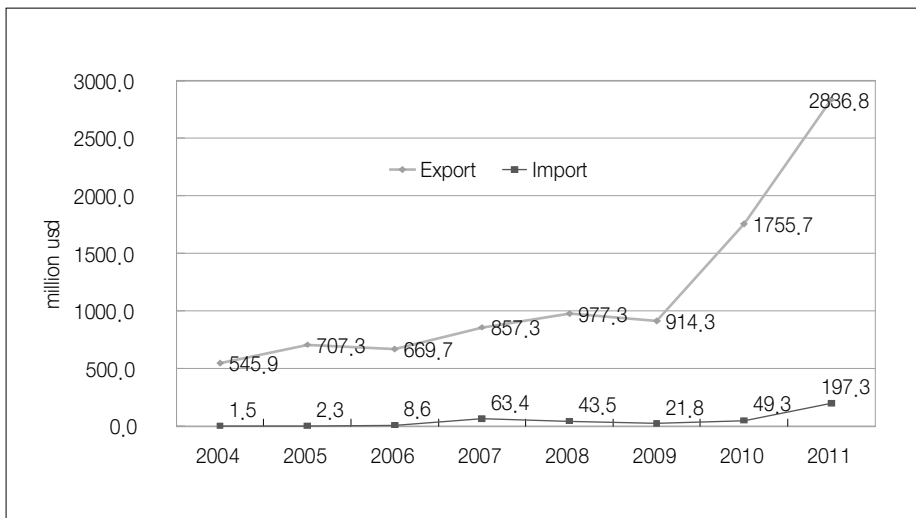
In the 1980s, more and more Korean automobiles have entered the international market. In 1986, automobile exports of Korea exceeded domestic sales of quantity for the first time. Currently, Korea has become one of the world's largest automobile exporters. In 2011, Korea exported 3.16 million vehicles, which represents 67.7

Table 8. Automobile Production and Exports in China and Korea (2011)

(Unit: 1000)

Classification	China	Korea
Production	18418.9	4,657
Domestic Sales	17604.6	1,475
Exports	814.3	3,152
Share of Exports	4.42%	67.68%

Figure 5. the Auto Export and Import of Korea to and from China



per cent of its total automobile production. In recent years, the automobile exports from Korea to China are always much larger than the exports from China to Korea, which proves that competitiveness of Chinese automobiles is still weaker than that of Korea. In 2011, the automobile exports from Korea to China reached 2.84 billion US dollars, while automobile imports of Korea from China were only 200 million US dollars; therefore the trade surplus reached 2.6 billion US dollars.

5.4 Internationalized Management of Automobile Enterprises

In China

For the automobile industry of China, overseas investment and international business is still in its infancy and in the phase of exploration. For example, in 2004, SAIC bought a stake in Ssangyong Motor, but by 2009 failed for many reasons. In 2010, Geely Automobile Co successfully acquired the Volvo Car Corp. Though there were attempts overseas investment, the overseas vehicle production capacity of Chinese auto companies is still so small that automobile enterprises in China are still far away from becoming real international businesses.

In Korea

The automobile companies have consistently expanded overseas investment and production capacity, leading to gradual increases in their level of international operations. In 2006 and 2010, the overseas production of Hyundai and KIA Motor group, respectively, reached 1 million and 2 million units, and in 2011 reached more than 3 million units. Currently Hyundai Motor has six overseas plants in the US, India, China, Turkey, Russia and the Czech Republic. Obviously, more and more overseas investment has given automobile enterprises of Korea greater competitiveness, making them more confident in the international auto market.

Conclusions

Firstly, Effective competition is an important driving force for promoting the development of the automobile industry. in China; high tariffs caused car prices to rise to excessive levels; excessive industry profits created massive automobile manufacturers, leading to lower industrial concentration; protection for existing enterprises led to insufficient market competition and slower technological progress;

high monopoly profits caused by high tariff barriers led to increased foreign investment. In the context of high trade barriers and low degree of market opening, joint ventures dominated the market rather than transferring advanced technology. Therefore, excessive long-term protection would have taken the auto industry into the trap of “protection---backwardness--continued protection --continued lag”. That is to say, international competitiveness of the automotive industry could not be cultivated through extended protection.

Secondly, independent development is the key factor for improving industrial competitiveness. For a long time, China has been hoping to achieve the objective of “market for technology”. But in the end, joint ventures only earned for China production technologies rather than key technologies of development. In fact, most of the automobile joint ventures in China continued to repeat the vicious cycle of “introducing technology--lagging behind--introducing again--lagging behind again”. It is readily apparent that the auto industry would always lag behind if the key technologies relied solely on foreign access. Therefore, in the face of international competition in the automobile industry, independent research and development is the inevitable choice in acquiring core competitiveness for the national auto industry, and is also in line with long-term interests of the domestic auto companies.

Finally, international operations are a rite of passage in improving industrial competitiveness. On the one hand, the auto industry of Korea has been more competitive due to its earlier access to international markets. As for the automobile industry of China, it is weaker in competitiveness partly because it has always paid more attention to the domestic market than to the international market. It turned out that only those enterprises with international operating capacity are truly competitive. In order to raise international competitiveness of automotive enterprises in a country, it is necessary for auto companies to participate in international competition through opening up when they acquire a certain capacity for independent development. That is to say, only through international competition will the auto companies be able to attain true competitiveness.

References

- National Bureau of Statistics of China. *China Statistical Yearbook, 2000-2012*. Beijing: China Statistics Press.
- China Association of Automobile Manufactures. *China Automobile Industry Yearbook*.
- Korea Automobile Manufacturers Association. *Korean Automobile Industry Annual Report*.
- Baozong, Fu. 2011a. "Challenge and countermeasure of nurturing dynamic comparative advantage in China—CHERY auto company as an example." *China Economic & Trade Herald*, Vol. 19.
- _____. 2011b. "Trend analysis and prospect of current demand for cars in China." *China Economic & Trade Herald*, Vol. 3.
- _____. 2011c. "Trend analysis of China's automobile consumption and recommendations from 2010 to 2015." *Macro-economy Management*, Vol 5.
- _____. 2011d. "Summary of the research on the competitiveness of China's automobile industry." *Auto Industry Study*, Vol. 10.
- _____. 2011e. "How to evaluate that auto consumption enter a period of universal in China." *China Economic Herald*. (January)
- _____. 2012. "Analysis of the factors affecting the competitiveness of China's automobile industry." *Macro-economy Management*, Vol. 5.



Private Economy and Economy Transformation in China

Liu Xianwei¹⁾

I. Introduction

Since the implementation of the reform and openness policy in 1978, China's private economy has been growing; it has become an important and strong engine promoting economic development, the industry structure transformation, the urban and rural prosperity and growth in employment; not to mention becoming an important part of the national economy and the pillar of China's modernization and creation of a moderately prosperous society. Now, China's non-public economy accounts for over 60% of the whole GDP, and over 75% of the city employment, over 85% of the new employment in cities; 90% of the labor transferred from rural areas go into the private enterprises, which has dramatically and irreversibly changed China's social and economic structure. Although China's private economy still has many problems such as irregularity, low innovation ability, dispersal and

1) Liu Xianwei is an Assistant researcher at the Institute of Economic System and Management (IESM), Academy of Macroeconomic Research (AMR), National Development and Reform Commission (NDRC), P.R. China.

small scale etc., it has become one of China's most important and active market actors, and has added momentum to internal inner development and the activity of the national economy as a whole.

The transformation of the economic structure and the mode of development has always been a frequent topic for research and daily conversation both in the academia and public administrative institutions. The Chinese central government had recognized the shortcomings and problems of extensive growth pattern long before and had made the strategic decision to transform the mode of growth mode. However, the transformation process moved slowly and with great difficulties, which shows that it is not easy to transform the mode of economic development and the transformation is a difficult but strategic issue China will be facing for some time to come. In the new phase and period of social and economic transformation, China must think of new strategies to promote the upgrade of the industry and given greater consideration to the importance of the private economy in the transformation progress. In the future, learning from the transformation experiences of other countries like South Korea, China's private economy will bring about more transformative effects and become the key and the decisive factor in the success of China's social and economic transformation.

II. Development of Private Economy in China

(1) Definition and Characteristics of Private Economy

Private economy is a special concept within the socialist market economy with many Chinese special characteristics; it is not a strictly legal concept. In China, the existing laws and policies divide the economy into different types such as state-owned economy, collective economy, personal economy, private economy and foreign capital economy according to the ownership structure of means of production. It is also part of what is referred to as "non-public-owned" economy

in China's Constitution, which includes personal economy, private economy and foreign capital economy etc. In this paper, we mainly talk about the private economy which is the most important part of China's so-called non-public-owned economy.

China's private enterprises have grown gradually in the very particular and special conditions of the socialist market economy system, which makes them very different from the counterparts in most western countries, and also very different from the state-owned enterprises. They have clearer property ownership, more flexible management system, more motivation for innovation, and more effective performance-related incentives contrasted to the state-owned and collective economy. These are the most important characteristics and the urgent requisites for China's efficient market economy development and industrial upgrade.

(2) Present Situation of Private Economy

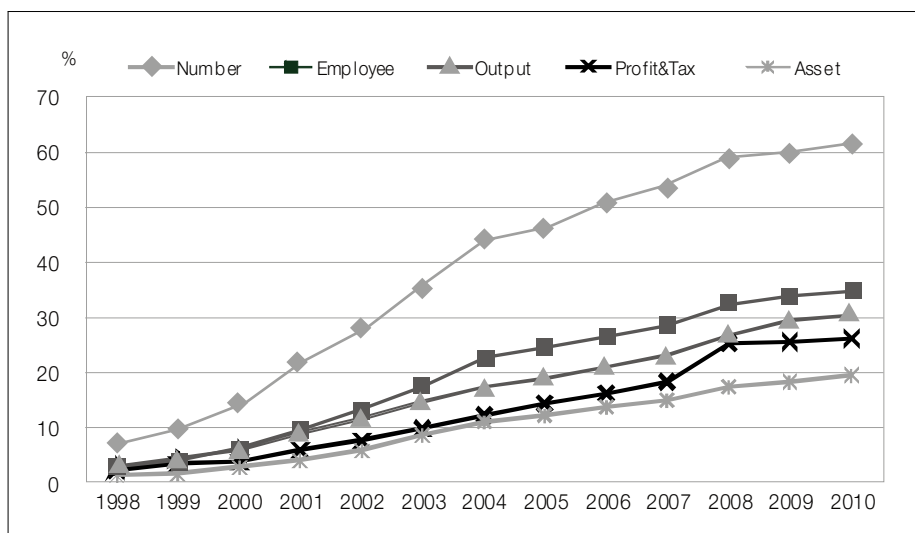
(2-1) Private Economy as the Most Important Part of National Economy

Private economy had once disappeared completely in the early period following the foundation of the PRC; it has undergone robust revival with the reform of the economic system and the foundation of the socialist market economy, to become the new and most important part of the national economy.

As for the number, there were 34.5 million individual small businesses and 4.7 million private enterprises in 2010, 2.3 times and 34.1 times that in 1992 respectively. Regarding industrial enterprises above the designated size, the main indices of private enterprises are all increasing rapidly during the past 10-plus years contrasted with the state-owned and foreign investment companies, such as the employee, the total industry output, the profit and tax, and the total assets etc.

As illustrated in Figure 1, Figure 2 and Figure 3 respectively in industrial sectors over the designated size, all the main indices of the private enterprises has increased dramatically in the past decade, especially in the number, the

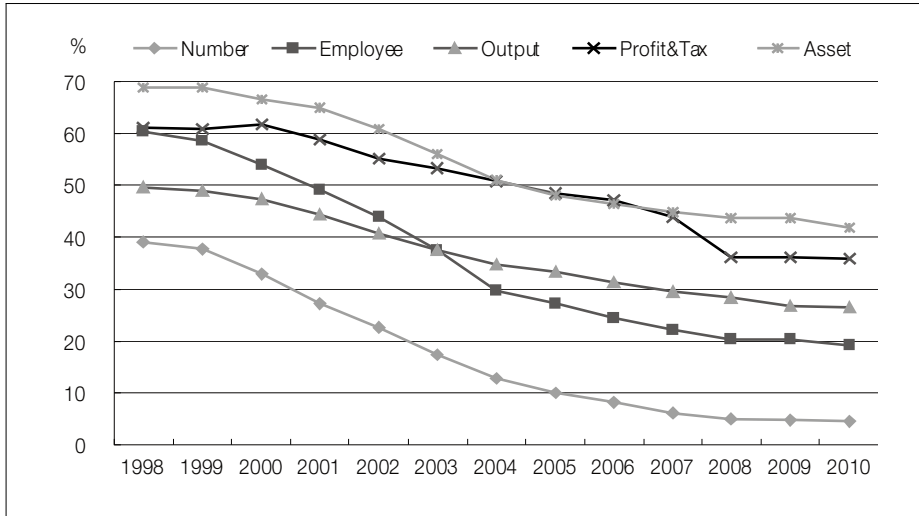
Figure 1. Development of Proportion of Private Enterprise in China



Resource: Calculated from China Statistical Yearbooks from 1999 to 2011.

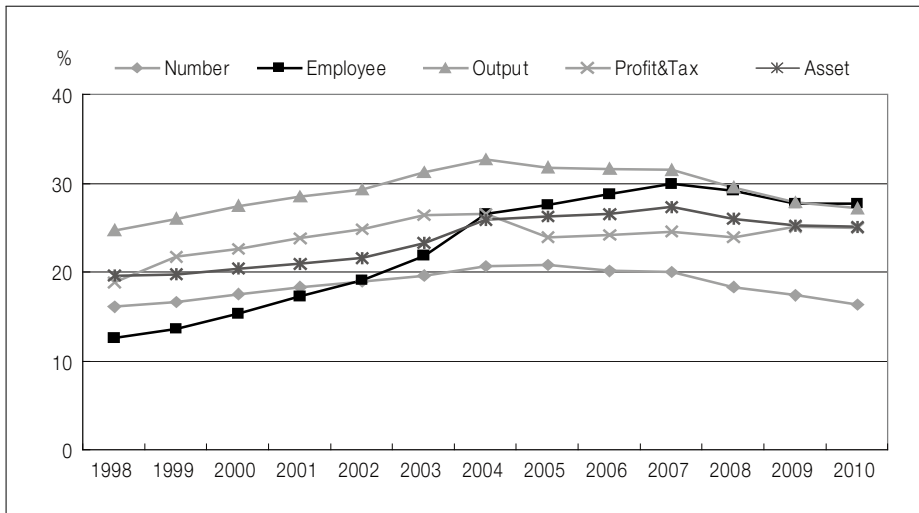
employee and the total industry output. In comparison, those of state-owned enterprises decreased sharply in contrast, and that of foreign investment companies stayed at almost at the same level during the entire period. The private enterprises have become more and more important since 1978 when the Chinese government implemented the reform and openness policy, and especially since 1998 and the coming of the new century.

Figure 2. Changes in Proportion of State-owned Enterprises in China



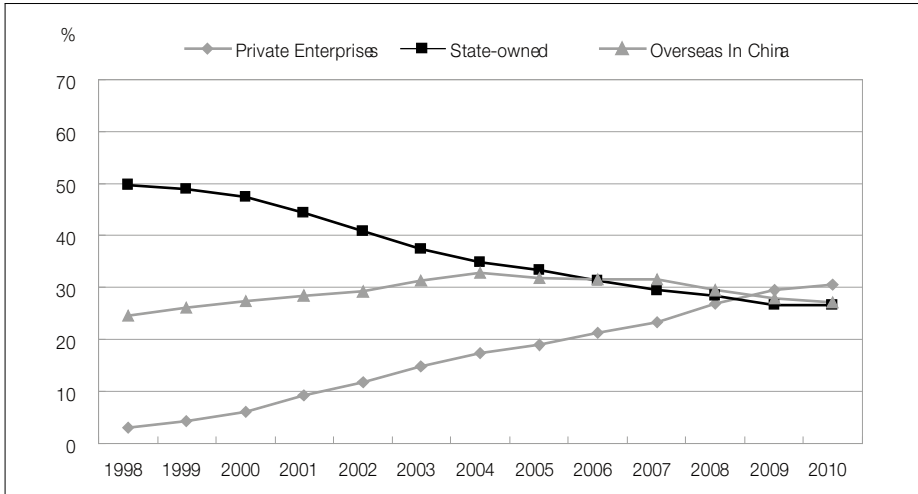
Resource: Calculated from China Statistical Yearbooks from 1999 to 2011.

Figure 3. Changes in Proportion of Foreign Enterprises in China



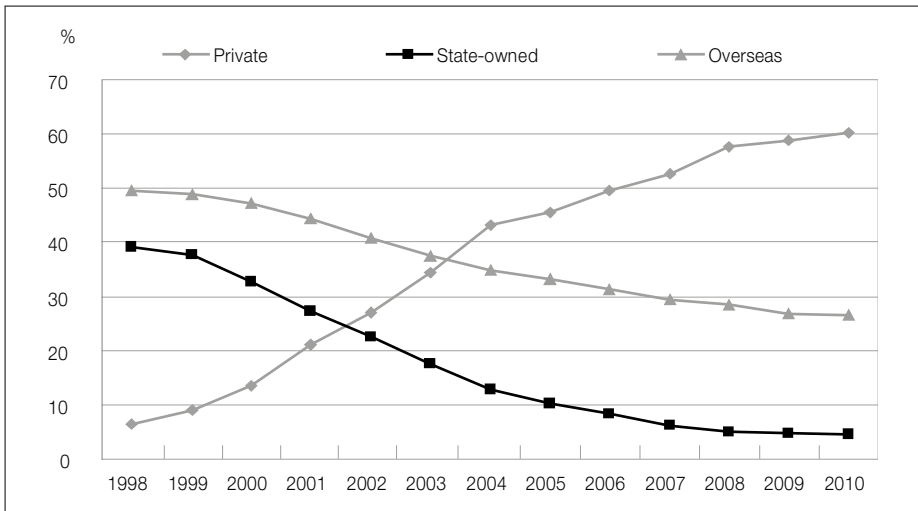
Resource: Calculated from the China Statistical Yearbooks from 1999 to 2011.

Figure 4. Industry Output Proportion Change



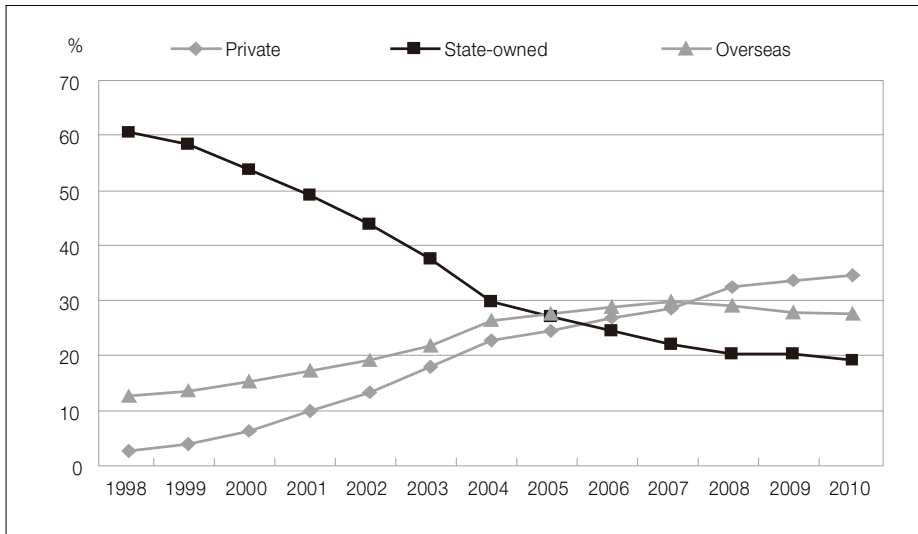
Resource: Calculated from the China Statistical Yearbook from 1999 to 2011.

Figure 5. Enterprise Number Proportion Change in Industry



Resource: Calculated from the China Statistical Yearbook from 1999 to 2011.

Figure 6. Employee Proportion Change in Industry



Resource: Calculated from the China Statistical Yearbooks from 1999 to 2011.

Up until now, in terms of the total industry outputs of industry enterprises over the designated size (which is the key indicator for industry), private enterprises grew steadily and surpassed the state-owned enterprises and the foreign investment enterprises. In terms of numbers and employees, private enterprises far outstripped state-owned and foreign enterprises in China and became the most important part of the industry over the designated size and even the whole industry, which is clearly shown in Figures 4, 5 and 6.

(2-2) Distribution of Private Enterprises

Since 1978, China's private enterprises have changed from none to many, from small to large, from weak to strong through a very long and hard development process. Now, as private enterprises achieve greater growth and maturity, and the industry and regional distribution become more reasonable and achieve greater

Table 1. Private Enterprise in Service Sector

	Number		Private (%)	Revenue(billion Yuan)		Private (%)	Employee (million)		Private (%)
	All	Private		All	Private		All	Private	
Wholesale	59464	35222	59.2	19775.9	4974.6	25.2	3.51	1.07	30.5
Retail	52306	28201	53.9	5111.6	1541.6	30.2	5.01	1.64	32.8
Hotel	15713	6250	39.8	281.4	73.7	26.2	2.11	0.63	29.7
Catering	21595	14553	67.4	317.8	159.3	50.1	2.20	1.12	51.0
Total	149078	84226	56.5	25486.7	6749.2	26.5	12.83	4.46	34.8

Resource: Calculated from China Statistical Yearbook 2011.

breadth. This gives greater power in promoting adjustments in economic and industrial structure; attaining harmony in regional economic development.

As for the industry distribution, the tertiary industry is one of the most important sectors with respect to private enterprises and individual businesses, which include such industries as wholesale and retail trades, hotel and catering services etc. Table1 shows the private enterprises larger than the designated size in the respective service sectors in 2010. There are 28.1 millions private and individual businesses in the tertiary industry, which account for 85.2% of total private and individual enterprises. The private and individual businesses are concentrated mainly in the wholesale and retail trades with 16.4 million, followed by the manufacturing industry with 1.5 millions private enterprises and 2.5 millions individual businesses, and thirdly, in the resident services and other services. These three sectors accounts for 76.7% of the total. The large number of private and individual businesses concentrated in the service sector creates the strong foundation for China's industrial transformation from the heavy industry, with greater resource and energy consumption, to the service industry.

As for the regional distribution of private and individual businesses, they are still much more numerous in the eastern coastal areas than in central and western areas; the private enterprises in the eastern China accounts for about 1/3 of the

whole nation. But develop gap in terms of private economy between different areas has been decreasing gradually in recent years. The rapid development of the private sector in the central and western areas has greatly increased local employment and income, and promoted the harmonious regional development between different provinces and areas in China.

(2-3) Great Attentions to the Private Economy

The private economy has undergone a series of policy changes from the strict restriction, to complements to the public sector, and finally to the important component of the national economy since the foundation of the PRC in 1949. Likewise, the historical status of the private economy has also undergone change in China. Since 1978, especially in the new century, the central government has issued a series of policies to encourage the mass of civil capital and the private enterprises to invest in the wide variety of sectors not forbidden by laws and regulations.

The central government has placed great emphasis on the private economy, and issued two very important guiding documents specially issued by the government for the development of the private economy in 2005 and 2010, simply named as “36 articles” and “new 36 articles” respectively which highlight the strategic importance of the private enterprises. Nearly all the ministries of the central government and the relative institutions have together issued a multitude of policies and measures to promote the private economy development from different fields and aspects since the “new 36 articles” issued in 2010. The private economy is now hailed as the vanguard of transformation of mode of economic growth mode by the whole nation, the central government and the society at large with the greatest hope and expectations.

(3) Problems of China's Private Economy

Mass amount of private enterprises, especially the small and medium-sized enterprises face many old problems such as financing difficulties, public service scarcity and the burden of high taxes and fees etc, while the big private enterprises exhibit problems such as the lack of innovation ability and core competence, making them "big but not strong". The private enterprises still have a very hard and long way to go towards achieve successful and innovative transformation.

(3-1) Restrictions of Private Economy

Although the socialist market economy has been set up in China unequivocally and the private enterprises can now operate freely in a wide variety of fields and industrial sectors, but there are still many implicit or even explicit restrictions in different areas - such as institutions, macro environments and monopolized market structure etc.

Firstly, the main restriction to private enterprise is the old notions and ideology which generally deem the private economy as "private exploitation" and distrust it with intrinsic prejudice. In fact, there is no definite relationship between the property ownership/fortune creation and financial credit in the modern market system. Most of the private enterprises can operate honestly and efficiently, generating much benefit to the whole society.

Secondly, the economy and government system is also a big impediment to the development of private economy. In some circumstances, the private sector is subject to more strict government supervision and policy restrictions, even unjust discrimination. On the other hand, state-owned and foreign investment enterprises receive favorable and preferential treatment in many fields including administrative public administrations, especially in projects that require approval by different public government departments.

Thirdly, the difficulties in financing the private enterprises encounter have remained a significant problem for a long time. The financial system that is mainly

controlled by the few large-scale, state-owned banks and institutions has not changed much and are unwilling to provide funds to the vast number of small and medium-sized private enterprises, which is the most fundamental reason for the said difficulties. It is very difficult for the private capitals to enter the banking system which are controlled by the large state-owned banks. Other financial channels are also strictly limited to private capital market and many other financial tools for the great majority of small and medium-sized private enterprises.

Last but not least, the a public organization exiting from a given industry represents a great opportunity for the private enterprise to enter into key industries with large output scale such as heavy chemical industry, energy and electricity, gas and petroleum, telecom, aviation, airline, ship building, shipment and many financial service sectors etc which are mainly monopolized by state-owned economy. The private enterprises still faces obstacles to market entry, colloquially termed “glass doors” or “spring doors”. In many sectors, the state-owned enterprises expand unlimitedly, even in sectors with fully competitive industries such as manufacturing, real estate, wholesale and retail, hotel and catering etc, which greatly reduces the existing space for development, leading to deterioration of the domestic entrepreneurs’ aspirations to set up large and competitive business groups.

(3-2) Void Supporting Policies

China’s private enterprises are very special and vulnerable because they have grown up gradually during the long process of economic system reform and transformation in which the state-owned and even foreign capital enterprises have become much more mature, competitive and preponderant. So it is very necessary for governments and public institutions to create favorable environments in order to promote their rapid, healthy development through robust policies and effective measures.

Though the central and local governments have issued a variety of policies and regulations to promote the development of private economy since 1978,

especially the central government in 2005 with the “36 articles” and in 2010 with “new 36 articles” to promote the private economy, but the results of policy implementation are not very satisfying because of a variety of complex reasons. The most important reasons include the impractical policy articles, the lack of implementation supervision and evaluation system and the strong resistance of interest groups such as government officers, state-owned enterprises and foreign investment enterprises etc., in the relevant industries.

Even until to now, the private enterprises’ fields of operation are still mainly limited to a small number of sectors such as traditional services, simple trades, hotel and catering and labor-intensive manufacturing. Other fundamental and strategic industries with huge markets and very high profits like energy, electricity, steel and iron, aviation, shipbuilding, telecom, construction and transportation etc., are, for the most part, monopolized by the large state-owned enterprises, and the remaining areas for the private economy are relatively small and unprofitable.

The “36 articles” and the “new 36 articles” has been widely cited and discussed by the economy and management researchers in China. Of these, the “36 rticles” which is now seven years old, but the most of the policy articles haven’t been fully implemented until today, and concomitant measures taken by a variety of departments and different level of government involve too many departmental interests, rendering many issued policies meaningless and the private enterprises still face many institutional and policy obstacles. Although the policies state that private enterprises can enter all industries unless explicitly prohibited by laws and regulations, it is in fact very difficult for the private enterprises to overcome the so-called “glass door” or “spring door” problem. Some media reports have come out stating that policies for private enterprises are almost useless; essentially “blank notes” that are limited and of very questionable effectiveness.

(3-3) Irregularities of Private Enterprises

The history of modern private economy in China is relatively short, so the

private enterprises themselves have many shortcomings such as demoralization, operation within one family, irregular management system, shortsighted activities and lack of long planning etc, which also prevents the healthy development of the mass private enterprises to some extent.

Some private enterprises face the problems of shortsighted activities, fulfill little in the way of social responsibilities, and pursue the abnormal rents and profits though all kinds of unjust measures such as relationship marketing, illicit advertisements, counterfeit and shoddy products, prohibited and unhealthy products, environmental destruction, irresponsible private lifestyles of the ownership, pursuit of abnormally high profit industries and overexploitation of employees etc, which greatly deteriorates the capabilities for sustainable development capability of the private enterprises along with their reputations.

Many private enterprises chose the extensive development mode which mainly depends on the relatively cheap natural resources, manpower and product price advantages, rather than intensive; investing less effort toward innovation and R&D of new products and technology. As a result, both the quality of and profits from the products are very low, making sustained growth very difficult for these enterprises and leaving them vulnerable to external market fluctuations.

A number of private enterprises, including large businesses, have yet to adopt modern methods of company operation. They are mainly managed by members of extended families, and are unable to utilize fully professional talents outside the company; these enterprises are thus heavily dependent on the authority of their founders and lack efficient, scientific system of decision-making, leading to dramatic deterioration of their market competitiveness.

Though the modernization and transformation of private economy remain a difficult strategic mission and still has a very long way to go, development of a healthy private economy is much more crucial to the development of the domestic economy as a whole and the social transformation, both of which are important to the sustained development of China in general. This is likely to determine directly the success of the economic transformation in China.

III. The Key for China's Economy Transformation

(1) South Korea's Economy Transformation Experiences

Since the 1960s, the South Korean government formulated and implemented proper industry policies in line with domestic and international economic circumstances, and Korea grasped the best opportunity for economic development after World War II. In several short decades, South Korea had achieved outstanding industrial development and became one of the four 'mini-dragons' of Asia and one of the biggest makers of automobiles, ships, electronics and semiconductors in the world.

South Korea accomplished both economic transformation and the industrial upgrade, and successfully entered the ranks of higher-income countries in a relatively short time. The per capita GDP had exceeded USD 10,000 in 1995 to reach USD 10,037 U.S. dollars and surpassed the USD 20,000 mark to USD 20,765 in 2010. South Korea's experiences of industrial upgrade and economic transformation are very valuable for China to learn and consult for reference. They are also of great value for in-depth and systematic study by researchers, which can greatly promote development of the private sector in China and its economy transformation.

(1-1) South Korea's Transformation Process

According to the current research materials available, South Korea's industry upgrading and economy structure transformation process can be roughly divided into several phases below.

1) Import substitution before 1961: Owing to the serious destruction of World War and Korean War, South Korea's economy went into a deep depression, and in order to deal with the serious scarcity of resources, capitals and technology, the government implemented the strategy of import substitution to protect and promote the consumption products manufacturing industry, in order to meet the

domestic consumption requirements and stabilize the economy and society. The policy produced great effects on subsequent economic recovery and growth.

2) Export orientation between 1962 and 1971: Due to the emphasis on the import substitution and ignorance of the importance of exports, mass importation induces large international trade deficits and high dependence on foreign imports. To ease the imbalance and establish good development ability, the industry policy orientation starts to turn from import substitution to export orientation gradually. From 1962 to 1966, South Korea became positive toward introducing technologies from overseas and prioritized development of labor-intensive industries oriented toward exporting. Meanwhile, the government also implemented a series of policies and financial mechanisms to promote exports, and established a lot of export promotion institutions. In April 1967, early days of getting into the GATT, South Korean government took full advantage of cheap labor force in the inland areas and predominance of textile industry in manufacturing to develop export processing, and made labor-intensive sectors such as the textile industry the main force of exporting, which created the basic conditions permitting South Korea to accumulate capital and technology.

3) Heavy and chemical industry development between 1972 and 1979: In the early 1970s, South Korea's industry policy switched its focus to heavy and chemical industry, and the strategy was to promote import substitution of raw/processed materials and capital goods and development of capital-intensive industry such as shipbuilding, steel, automobile, metal, oil and chemicals. The government enacted many measures to encourage these so-called strategic industries, including foundation of the national investment fund to provide low interest loans to amass investment financing, protecting the new industries until they acquired international competitiveness, and allowing some large companies to establish monopolies regarding certain products to overcome the relatively small domestic markets.

4) Technology-intensive industries development between 1980 and 1990: In the 1980s, in line with the global technological revolution, South Korea's industrial

strategy began emphasizing science and technology, promoting the transition of the industry structure to one dominated by technology-intensive industries such as electrical machinery, electronics and information technology. The government provided much support for high-tech industries such as synthetic (fine) chemistry and instruments, computers, aviation and spaceflight. This confirmed the newly-emerging industries as information, new materials and biological engineering as strategic development priorities, while upgrading the traditional industry such as textile, concrete, petrochemical, steel, household appliances, automobile and shipbuilding with advanced technologies to increase the exporting advantage, effecting a rapid upgrade of industrial structure to a new stage.

5) Industry organization optimization with high-technique after 1990: Since the Asian financial crisis, the South Korean government reassessed its the past industry policy; reformed the finance, business, labor market and public sectors. The government also confirmed its main orientation for industry transformation: optimization with high-technology in line with the worldwide information wave in the world and adjustment of the industry organization structure based on big business groups. At the same time, the government also encouraged the small and medium-sized enterprises to foster capabilities for innovation through a wide variety of supporting policies with respect to finance, tax, land and technology; and promotion of collaboration among industries, universities and research institutions to foster the an environment favorable to innovation. Since then, South Korea's industry has been upgraded greatly with massive technological input, and the industry structure of the three industries transformed from 8 : 46.1 : 45.9 in 1991 to 4 : 34.7 : 61.3 in 2001, leading to great enhancement of industrial competitiveness on the whole.

(1-2) South Korea's Transformation Experiences

In the 21st century, facing the novel situations regarding development, there are urgent requirements for industry transformation in South Korea that need to

be taken care of alongside adjustment of macroeconomic policies. So researching the experiences and lessons of South Korea's industrial transformation and upgrading is very necessary both for Korea and China, especially for development and transformation of China's private sector.

As for Korean experiences, firstly the Korean government played a great role in the entire transformation process. The central and local governments issue and take a variety of effective policies and measures to promote the economy and society to develop and transform, as well as the industry, and created favorable environments for the transformation of the whole country. For example, the "New Village Movement" had greatly transformed and upgraded the social structure of South Korea and created vast domestic product and service market for the domestic enterprises. Korean government also implemented a variety of financial and tax policies to encourage R&D to promote technical innovation and expedite the upgrading of its industry.

Secondly, the national economy explicitly focuses on some predominant and strategic industries. South Korea is comparatively a small country with about 50 million people and a relatively small market. It is nearly impossible to develop all the industries to a large scale with limited land, resources, labor forces, capital accumulation and domestic markets. So the companies in the main industries invest enormously on some specific industries which they have big relative advantages such as steel and iron, automobiles, ships, electronics and semiconductors etc, and have achieved great success in all these main strategic industries.

Thirdly, the main companies invested intensively in R&D, with much emphasis on technical innovation and the transformation of the structure of traditional industry as well as new strategic industries such as semiconductors, telecom, aviation and healthcare, and enhance the quality, the imbedded science and technology; which added value to traditional products such as clothes, concrete, construction, iron and steel, ships and automobiles, etc.

Last but not least, huge business groups are established on almost every major strategic industry along with other industry sectors; for example, Samsung and

LG in electronics, Hyundai and KIA in autos. In order to enhance the core competence in the global competitive market, the enterprises set up big business conglomerations to fully utilize the economic effects of scale.

Unfortunately, as of the present, China's private enterprises are still relative small and dispersed in a number of industries, and have not yet set up industry-leading business groups to establish their core competences in the competitive global market, which makes it much more difficult for them to transform and step up.

(2) China's Economy Transformation

(2-1) Economic Growth-pattern

In traditional economic theory, the economy's growth-pattern can be divided into two types, the extensive growth which depends mainly on enhancing the mass material inputs, and the intensive growth which depends mainly on the enhancement of output efficiency. With rapid economic development come greater pressure on environmental and natural resources along with energy scarcity, meaning sustainable development is nearly impossible with a continual extensive growth pattern.

The economic growth-pattern can also be divided into the investment-driven mode where investments contribute the most, and the efficiency-driven mode in which the greatest contribution is made by enhancement of the Total Factor Productivity (TFP). Unfortunately, China's economy has continued along the path of extensive and the invest-driven growth for quite a long period. Though China has achieved great success in constructing a modern economy, its ability for sustainable economic development is also deteriorating. Economic and social problems that arose in the development process is becoming more prominent, and must be resolved as soon as possible.

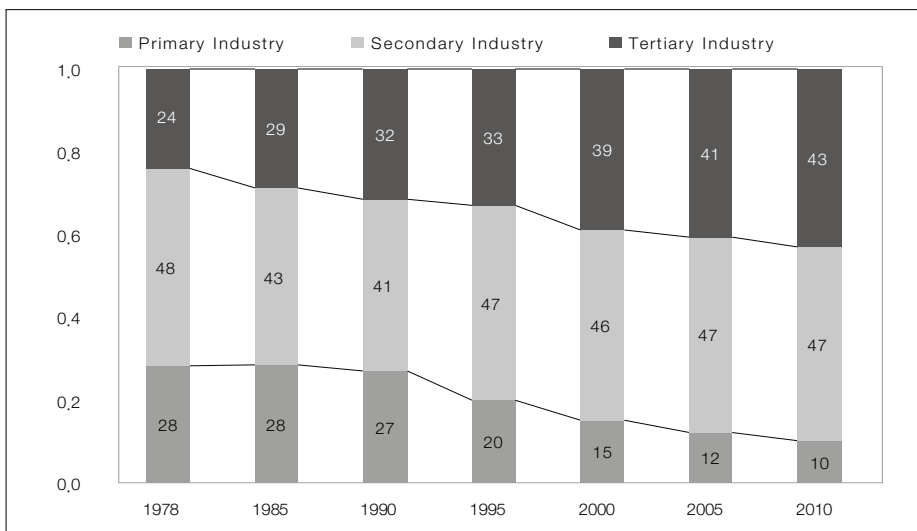
(2-2) Economic Transformation Puzzle

Structural problems in the economy has seriously hampered the quality of China's economic growth and the coordinated development of the economy and society, long before including industry structure, final demand structure and factor investment structure entered the equation.

As for the industrial structure, as a result of China's economic development dependent on vast investments, proportion of the secondary industry increased greatly; the tertiary industry lags far behind, developed slowly and accounts for a very low percentage as shown in Figure 7, especially in modern services and public services. The level of social development is also very low, which directly resulted in some industry overcapacity while the public product supply remained seriously inadequate.

As for the final demand structure, the economy has been subject to a state of significant imbalance of three demanding carriages for a long period. Since

Figure 7. China's Industry Structure Change



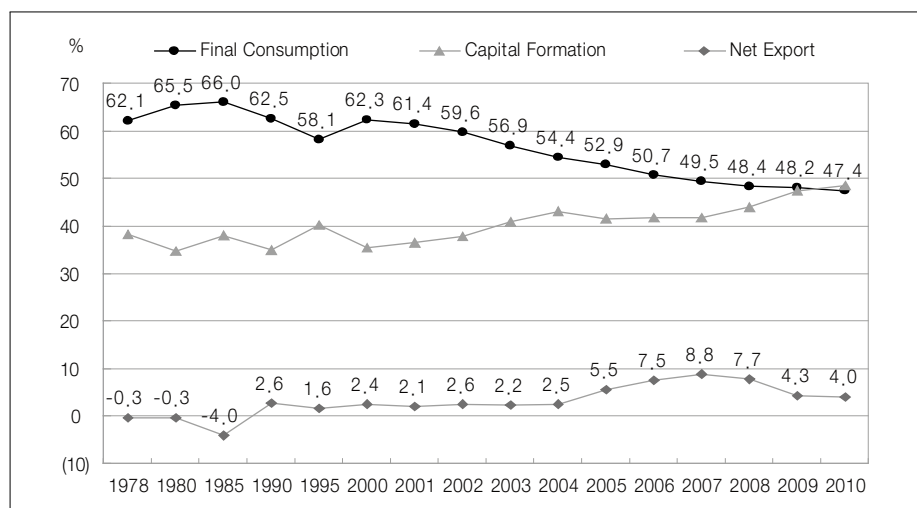
Resource: Calculated from the Related China Statistical Yearbooks.

the middle 1980s, the final consumption in the proportion of GDP has decreased from 66% in 1985 to 47.4% in 2010 as shown in Figure 8. In contrast, in 2010, the data for the U.S.A. is 70.1% and 54.7% in India. The consumption rate of residents in China is not only much lower than the developed countries, but also compared to most developing countries.

As a measure to boost the economic growth and overcome the financial crisis in 2008, USD 4 trillion investment plan of China's central government further exacerbated the imbalance in the final demand structure, and the investment-driven growth pattern actually intensified. So the relationship between the economic growth and the structural transformation is a very difficult dilemma in China for which no resolution has been forthcoming for a long time.

As for the structure of factor investment, up until the present, the economic growth was still dependent mainly on increased consumption of material resources and manpower. The level of contribution from progress of science and technology and the technical innovation stayed relatively low. Economic growth leaned too

Figure 8 China's GDP Composition Change by Final Demands



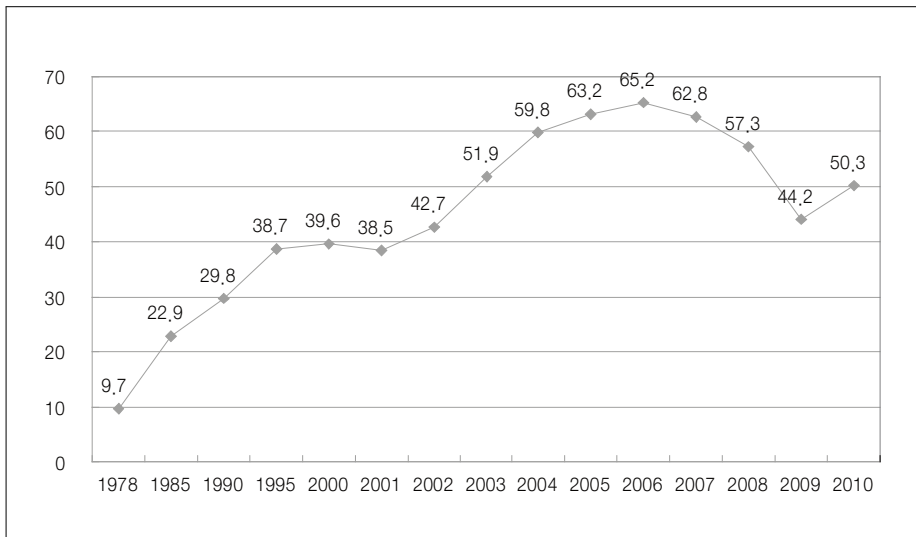
Resource: Calculated from the Related China Statistical Yearbooks.

Table 2. Comparison of Foreign Dependence Ratio (2007)

Countries	Dependence (%)
China	62.8
World Average	51.8
USA	23.0
Japan	30.4
German	71.8
India	32.9
Brazil	21.9
Korea	76.1

Resource: Calculated from China Statistical Yearbook 2008.

Figure 9 China's Dependence Change on Foreign Trade



Resource: Calculated from the relevant China Statistical Yearbooks.

heavily on investments and exports to change the economic structure in a short term, which made it very difficult to increase the consumer consumption ratio because the domestic income could not keep pace with a rapidly developing economy.

China's macro-economy has been becoming increasingly more dependent on exports and foreign trade since 1978 and the foreign trade dependence ratio²⁾ had reached a peak of 65.2% in 2006, but tapered off in the latest few years, especially since the newest world financial crisis in 2008, which is shown in Figure 9. As shown in Table 2, China's dependence on foreign trade 62.8% is still high relative to the world average of 51.8%, and significantly higher than the major economies such as the USA (23%) and Japan (30.4%) in 2007, prior to the world-wide financial crisis.

In the long term, in order to transform the development pattern successfully, firstly, the economic growth pattern must be transformed from one focused on quantity and rapid growth to one emphasizing quality and efficient growth; secondly, the social structure must move away from the urban-rural dichotomy to urban-rural integration; thirdly, the public administration must change from a government of construction and control government to a government of public service. In order to realize all these changes, the social system and policy arrangements adapted to industrial production and economic growth must be reformed comprehensively in order to meet the requirements of a consumption society, and the role and the transformation of private enterprises must be considered carefully in this historical reform process.

2) Foreign Trade Dependence implies the dependence of the economy on imports and exports. The ratio is calculated as the percentage of the total imports and exports to the GDP of the particular economy.

(3) Transformation Progress of Private Enterprises

(3-1) Competence of Private Enterprise Becoming Much More Stronger

Recently, the economy developed new features as a result of the growth of the private economy, and there were huge leaps in overall strength, the innovation capability and the competitiveness of private enterprises. The private enterprises have begun to make preliminary moves in the transformation of the development mode which is of historical importance to China's sustainable development.

In terms of industry distribution, there was transition from labor-intensive and traditional industries such as textile and clothing to capital-intensive and technology-intensive industries such as car manufacturing, steel, telecom equipment and computers; from service and tertiary industry to strategic new industries and many other industries; the industry distribution of private enterprises has been becoming wider and more diverse, and the role of private enterprises is taking on increasing importance.

In addition, many private enterprises with strong comprehensive competence are emerging as large business groups and forming industrial clusters characterized by large scale and specialized operations. The average size of private enterprises has been growing continuously. Many private enterprises have introduced outside investors and set up modernized company control-and-ownership structures which are crucial to long-term continuous development.

Among China's top 500 enterprises in 2011, 184 are privately-owned, accounting for 36.8% of the total, 13 more than the previous year. As for the top 500 manufacturing enterprises, the amount of private enterprises increased continuously, from 275 in 2009 to 281. And as for the top 500 service enterprises, the number of private enterprises reached 222 or 11 more than in 2009, accounting for 44.4% of the total. It is safe to conclude that the strength and competence of private enterprises have been enhanced tremendously.

(3-2) Innovation and R&D of Private Enterprises

Up until now, R&D and innovative competence and human resource were sufficiently adequate for private business transformation and upgrading. Since the start of reform and openness, about 70% of the technical innovation, 65% of national invention patents and more than 80% new products are created by small and medium-sized enterprises, while more than 95% of the small and medium-sized enterprises are not state-owned but private businesses. In the 56 state-level high-tech development zones, the number of private enterprises with a high level of science and technology accounts for more than 80% of the total. As for the high-tech enterprises accredited by central and provincial governments, private enterprises accounts for 70% in Beijing, Shanghai and Jiangsu; 80% in Guangzhou and Shenzhen, and over 85% in Zhejiang.

R&D institutions, R&D funds and innovative talents have gradually begun to aggregate to the private enterprises as well. For example, the annual R&D expenditure of Huawei Company in Shenzhen accounts for over 10% of the total sales revenue, and the R&D investment reached as high as 7 billion Yuan, with the number of international patent application totaling to 1600, ranking first in the global business world in 2009. Many private high-tech companies such as ZTE, Tencent and EVOC also attained strong competitiveness in both the domestic and international markets due to increasing investment in R&D, efforts to attract new talent, and utilizing its innovative capacity, and not only is able to consolidate the existing market, but also to create new market demands. Relying on keen market insight and continuous innovation, private enterprises such as Geely, Huawei and so on have created their own brands and achieved remarkable success. In 2011, among China's top 500 enterprises, the average R&D intensity³⁾ of private enterprises is 1.8%, much higher than that of state-owned enterprises at 1.34%, showing that private enterprises have greater will and motivation with respect to innovation.

3) Average Intensity of R&D is calculated as the proportion percentage of the total R&D expenditure to the total sales revenue.

(4) Transformation Role of Private Enterprises

(4-1) Private Economy Promote Civil Wealth

Under the concept of the socialist market economy, the private economy can greatly promote the civil wealth while the state-owned economy promotes the national prosperity. So in order to increase the domestic disposable income and the consumption, China's future development strategy should concentrate on stimulating the entrepreneurial passions of the Chinese population, and promote the economic development with greater impact on ordinary people such as community economy, consumption economy and service economy; which would mean more ordinary people would become wealthier in line with national development.

The private economy has already become the most important channel for resolving the unemployment problem and increasing worker incomes, amidst the particular conditions of China with respect to labor supply where the unemployment problem has been and will be the biggest social problem for a long period. The development of state-owned economy failed enhanced employment level, and during the process of state-owned enterprise reform, unemployment skyrocketed. The number of staff and workers in public-owned sectors increased from 74.5 million in 1978 to 112.6 in 1995, and then began to decline continuously, to only 81 million by the end of 2000, and even down to only 65.2 million by the end of 2010. Since 1978, the number of employees in state-owned sectors has not risen, but fell dramatically instead, even as the state-owned economy was undergoing development as well.

In contrast, the non-public owned economy has sustained the rapid development trend and contributes significantly for the economy development and social employment. At the end of 2010, the number of private companies has already amounted to more than 4.7 million, accounting for over 70% of the total companies in China. The new employment in urban areas and labor transferred from rural areas almost all go into the private economy and the laid-off workers

from the state-owned enterprise are also go to private enterprises. Now, most importantly, more than 200 million migrant workers from rural areas are work in the private enterprises. Recently, private enterprises have become the main destination for the employment of new college graduates.

In China, more than 60% of the income of urban residents and nearly 40% of the income of rural residents come from wages or salary, which means the improvement of people's living standard is closely related to the development of private enterprises where most of them work. The enhancement of wage levels mainly depends on the healthy development of the private sector, especially as the proportion of the private sector is becoming larger and larger. At present, the level of worker wages and salaries is not only much lower than most developed countries but are also lower than many developing countries, which results in a low consumption rate of only about 45% for China, about 20 percentage points lower than the world average. Relative studies have shown that, if the consumption rate increases by 1 percentage point, the economic growth rate will increase by 1.5 to 2.7 percentage points in China. So the rapid development of the private sector will promote income increases which will greatly improve the consumption level of urban and rural residents. This would represent a development of a new axis for economic growth and the new powerful motive force for economic and social development and transformation.

Furthermore, the private economy has become the most important support for the county-level economies which covers most of the Chinese mainland. The vast numbers of China's counties are increasingly becoming the new focus of economic and social development and another axis of growth for the regional economy. As they still hold the bulk of China's massive population, the harmonious and integrative development of urban and rural areas is strategically important to the creation of a "well-off" society and the harmonious development of the economy and society. With respect to the vast economy of China's counties and regions, private enterprises play the most important role in expanding urban and rural employment, increasing taxation, increasing product and service supply, while

continuing to satisfy the people's growing material and cultural needs. Private enterprises participate in market competition more actively and promote domestic market construction, as well as stimulate free thought and development of ideas among the populace. This, in turn, would promote the transformation of government functions and the establishment and consummation of the socialist market economic system.

In various economic sectors, the financial tax revenue from individual and private enterprises is growing most rapidly, significantly higher than the national average level and other types of enterprises; their share of contribution have been increasing continuously. At present, in the majority of counties, the local economy is mainly driven by individual and private enterprises which are also the main source of local financial revenue. In recent years, industrial clusters characterized by mass private enterprise congregating round a particular county developed rapidly, and some of them have become the most important base for manufacturing with products occupying a very high market share in the country. Many private enterprises have become leaders among local small and medium-sized enterprises, which provide great boost to the rapid economic and social development at the county level.

(4-2) Easier for Private Enterprise to Transform

The private enterprises are more sensitive to the direction of economic and social developing and development trends in the world, and can achieve transformation and upgrades more easily. The development and transformation of private enterprises will be the main factor that drives the transformation of economic development pattern in the "Twelfth Five-Year Plan", and especially, the large and medium-sized private enterprises should become the backbone of China's transformation.

At present, there have been more and more private enterprises beginning to get involved in high-tech, modern service and other high industries, including new

strategic industries such as new generation IT, biotechnology, new energy, new materials, new energy automobile, and many private enterprises have already achieved great results. In the future, the emergence of new industries will further lead large numbers of private enterprises to participate in the new industrial wave, and concomitantly, new development and industrial patterns. In addition, the explicit property ownership structure and the strong innovative drive among private enterprises with strong entrepreneurship are all potential forces that could push China's transformation.

The operation and management of private enterprises are much more efficient, and it is very difficult for the state-owned enterprises to keep up in terms of achieving high efficiency. Private enterprises are mostly small and medium-sized, owners are also operators, and they understand the basic practical business information so that there do not exist the problems such as "information asymmetry" and "lack of motivation", which is the biggest congenital advantage of business efficiency. The research results from International Monetary Fund (IMF) show that, according to the added value, the capital return rate of Chinese private enterprises is 50% higher than the state-owned enterprises, 33% higher than the enterprises controlled by state-owned shares, and 24% higher than the enterprises with assistant state-owned shares.

China's Top 500 Enterprises Development Report 2011 shows that, 316 state-owned enterprises posted profit margin and asset return rate of 5.67% and 1.75% respectively, less than that of 184 private enterprises which are 6.05% and 3.63% respectively, especially the asset return rate of state-owned enterprises is only half of the private enterprises. The asset turnover of state-owned enterprises is 0.31 times per year, much lower than that of private enterprises which is 0.6 times per year. The operating revenue and the profit per capita of state-owned enterprises are 1.3 million Yuan and 73.2 thousand Yuan respectively, also lower than that of private enterprises which are 1.6 million Yuan and 96 thousand Yuan respectively. In terms of the main indicators such as profitability, operation efficiency, labor productivity, capital structure, R&D expenditure and the market

evaluation etc, the performances of private enterprises are all superior to state-owned enterprises, and the efficiency advantage of private enterprises have continued to expand in recent years, and the private economy has more powerful incentives for innovation and transform.

Furthermore, private enterprises have to face more severe external pressure from the market that comes with strong pursuit of profit maximization, and the management also has stronger incentive mechanism, which promotes the continuous innovation to gain competitive advantages. It is the great force of innovation that drives private enterprises to apply new knowledge, new technology and new manufacturing processes; adopt a new mode of production and management, develop and produce new products and services, and improve product quality and market competitiveness to gain market value. As a result of clear property rights, private enterprises will have full autonomy of internal right distribution, and are also able to introduce, freely acquire and secure the most talented people, to utilize their talents and motivate them to do their best for the businesses. The salary distribution criterion accords with the contribution to the business, which is conducive to stimulating the staff's enthusiasm, initiative and creativity for continuous technological innovation and improvement of labor productivity. In contrast, the management system of state-owned enterprises are lagging, as adequate profits can be made easily through monopoly positions in given markets, which leads to a lack of motivation of state-owned enterprises to innovate and transform. In 2011, among China's top 500 enterprises, the average R&D intensity of state-owned enterprise was 1.34%, much lower than 1.8% rate among private enterprises.

(4-3) Decisive Role of Private Economy in the Growth Mode

Since 1978, especially after the 1990s, the private sector has made considerable strides and contributed a lot to China's economic and social development and the comprehensive enhancement of national competence. At present, the private sector

has become the most important component of the national economy, and distributed widely among many industries, even taking a dominant position in many areas. The investments from non-public enterprises has exceeded 50% of the total social investments, and investments by non-state enterprises has exceeded 50% in 27 of the total 40 industry sectors, more than 70% in certain sectors, and become the main impetus for industrial development. In many areas, the private sector has become the main driving force of growth. For example, individual and private firms have accounted for more than 70% of the local GDP in Zhejiang province. All the facts have fully proven that the private sector is the main source of inner development power of China's development and transformation.

However, the development of private economy still faces many restrictions, and is not mature enough, and the task of transformation and upgrading is still very hard. A large number of private enterprises still face many old problems such as "big, but not strong." There is still a long way to go regarding the transformation of private economy given extensive development still required, low innovation ability and core competence etc.

As a whole, in the future, the scale, the market power and the strategic position of private enterprises will rise even further, which will position the private sector to play a decisive role in national economic and social development. If the non-state sector which accounts for more than 65% (will be higher and higher) of the total GDP cannot change the development pattern and show a trend of positive and healthy development, it is almost impossible for China to achieve the strategic economic transformation. The development of the private sector will increasingly determine the pattern of China's economic development, and the key to achieving successful transformation is to actively support the development of the private sector, to change the development pattern of non-government sector, and to improve effectively the quality and the innovative ability of private enterprises.

IV. Historical Mission of China's Private Economy

Much more needs to be done in the new stage of development in China for the transformation of development patterns, which is increasing in urgency as a historical mission. Chinese central government has always taken it seriously as an important strategic task. In connection, the private sector is playing an increasingly decisive role in the transformation process. To increase policy support and to create a favorable development environment, the private economy will need to expend even more energy, and gradually take over and complete the historical task of transformation.

(1) New Developing Stage Need New Development Pattern

In terms of current economic and social structure, on the whole, China has already crossed the early stage of industrialization in which the national economy takes off and grows very rapidly. It now entered the middle phase of industrialization, a crucial point in transformation into a high income country. The successful completion of the development into a society with high consumption and higher quality of life, which are the main characters of advanced stage of development, mainly depends on the effects of the transformation of economic and social structure and the concomitant administrative system reform. This is very crucial in avoiding the pitfalls of the so-called "Middle Income Trap" and becoming a high-income country, which is closely related to China's core national interests.

In 2008, China's GDP has reached 31.4 trillion Yuan (equals about 4.6 trillion US dollars), and GDP per capita reached \$3463 for the first time, crossing the significant \$3000 threshold. By 2010, China's per capita GDP has reached \$4384, over \$4000 for the first time. According to the World Bank criterion, China had already turned from the lower middle income country into an upper middle income country,⁴⁾ a significant achievement for all Chinese.

In the “Twelfth Five-Year Plan” period and much further beyond, the main issues in China still include development pattern transformation, industrial structure optimization and upgrading, regional and urban-rural integration, development stage and “Middle Income Trap” transition, and entry into the consumption society with high income and higher quality of life, and finally achieving a successful economic and social transformation. An important outward evidence of a developed and high income country consists of proportion of consumption in GDP and high domestic income, and the industrial structure where a high proportion of second industry is superseded by high proportion of tertiary industry. Now that China is changing into a high-income country, , China needs new development pattern for this new transformation stage, and the role of vast private enterprises will be decisive and irreplaceable.

(2) Transformation is China’s Most Important Strategic Mission

Frankly speaking, on the subject of changes in economic development patterns, Chinese central government anticipated it quite early and quickly, and has made a series of decisive decisions. In early 1995, the central committee of the CPC made a clear decision clearly to change the economic growth pattern, and took it as one of the “two essential changes in an overall sense” together with the economic system reform. In the second year, the government working report puts forward that the essential transformation of the economic system and economic growth patterns should be promoted actively and deeply. The government emphasized at the same time that, in order to achieve the goals of the future 15 years, it is crucial to transform the economic system from the planned economy

4) In World Development Report 2010, World Bank ranks countries with Gross National Income (GNI) per capita at \$975 and below as low income countries, GNI per capita between 976 and 3855 dollars as lower middle income countries; GNI per capita between 3856 and 11905 dollars as upper middle income countries; GNI per capita over \$11906 as high income countries. World Bank: “World Development Report 2010”, Tsinghua University Press, Jun., 2010.

system to the socialist market economy system, and transform the economic growth pattern from an extensive to an intensive model. In the following several years, Premier Zhu Rongji emphasized giving great considerations to adjusting and optimizing the economic structure, and improving the quality and efficiency of economic growth, on many occasions including the yearly government working reports. And messages and articles on the transformation of economic development pattern have appeared frequently in government documents and many magazines and newspapers.

In recent years, Premier Wen Jiabao again spoke out on expediting the transformation of the economic development pattern and the economic structure adjustment in yearly government working reports and at many other occasions. Starting with general efforts, the economic development pattern transformation has achieved visible effects step by step since 1995, but the overall effects of reform have not been satisfactory, as there were too many problems that people wanted resolved.

Now, China is at the development phase similar to the stage in which the western countries went from the industry growth mode of the first industry revolution to that of the second industry revolution. As for the development process of western industrialized countries, after the first industrial revolution, economic growth was driven by investments, with dominant industries being heavy industries such as iron and steel, auto and chemistry etc. This model, of course, had brought about a series of economic, social and environmental pollution problems. But as the developed countries have transformed into high income societies, the energy and natural resource consumption per GDP has been lowered.

At present, compared with many western developed countries, China's energy consumption per million dollars of GDP is 3 times as high as US, 5 times that of Germany and nearly 6 times that of Japan. The efficiency of 1 ton of coal in China is only about 28.6% of the United States, 16.8% of European Union, 30%~10% of Japan. And the economic growth costs are over 25% higher than the world average level. The huge energy consumption with low efficiency has

led directly to the great public relations pressure on China at the global climate summit in Copenhagen in 2009. Furthermore, in the foreign trade market, Chinese enterprises often become the target of Europe and American trade sanctions. So some researchers say that, given the present situation, China consumes a lot of non-renewable resources, destroys the local environments, but is notorious for dumping, and ultimately makes little money.

Undoubtedly, China's economy must grow relatively rapidly to overcome many domestic developing problems. Frankly speaking, to a certain extent, the growth has heavily relied on the extensive investment of production factors such as capital, labor force, energy and the natural resource etc for a long time. In the future, even if China can restore economic indicators temporarily through blind continuation of the traditional growth pattern, it would lead to lack of confidence and sustainable capability. For China, the economic development pattern transformation is a long and difficult but very urgent strategic mission which cannot be overlooked. It is necessary that successive governments and the whole society to continue the relay progress far into the future.

(3) Private Economy is Strategic Support for Transformation

Private economy is the most important in strategic support for the transformation of economic development patterns due to the particular characteristics which state-owned enterprises don't have. As for the present social and economic structure, China has already entered into the middle stage of industrialization and became upper middle income countries. It has also made its entry into a crucial period of development stage transition and the economic and social structure transformation.

In order to progress further toward a high income country, the proportion of middle class must become large enough and account for more than 70% of the total population, and the society's consumption ability must be enhanced

dramatically. On the other hand, inequalities that arise in development and the big gaps between urban and rural areas, between different provinces, and between different groups must receive closer attention. To solve these problems, there must be deep and wide-ranging reforms in the administrative management system and social management system. In addition, the avenues through which low income groups can change their status must be widened greatly which will gradually reduce the proportion of the poor and low income groups, increase the proportion of the middle class, promoting a transformation in the social structure to change from a “dumbbell” which is large at the two end and small in the central part to an “olive”; large in the middle and small at the two ends.

Due to the particular political and economic environments, China’s private economy, especially the individual/private sector has some special characteristics into contrast with the state-owned/foreign investment sector, which makes it more important and effective in increasing urban and rural wages and income, transforming the development pattern and promoting the development stage transition, and playing a more important strategic role as a whole. The private economy has been playing and will play an even more important supporting role in creation of a well-off society in China and its successful transition to high income countries.

(4) Private Enterprises should become the Key for China’s Transformation

In the future, the private economy should become the key for solving the contradictions in economic structure which has perplexed China for quite a long time. Since the reform and opening up in 1978, private enterprises have become the most vigorous and active part of China’s national economy. In the industry over the given size, the number of private enterprises has surpassed those of state-owned, foreign capital enterprises and all the others, and accounted for over 60% of the total in 2010. As for registered capital, output value, social retail sales,

or in tax contribution, employment, net exports and many other aspects, the private enterprises has all but become the main driving force that promotes economic growth, and contributed much to the sustained and stable economic development and economic systems reform. As new forces in national economic development, private enterprises have been playing and will play an irreplaceable role in enhancing comprehensive competence, upgrade the industrial structure, and maintaining the national economy to sustain a rapid but stable growth.

In the long term, in view of consumer psychology, only when the good income and the relatively stable living is realized in the future will they could have the strong consumption ability and willingness to consume all types of products and services; in conjunction with higher-quality consumption where energy and resource is kept low. This would contribute dramatically to the economic transformation and industrial upgrade. Fortunately, the private sector is likely to play an effective role in increasing employment and income, and the enhancement of the consumption ability of urban and rural residents. Needless to say, the private sector is of greatly strategic significance for China is raising the whole nation's consumption level and in overcoming serious economic structure problem.

As discussed above, private sector is also the most active part in China's economic and social development, and will be even more active in developing the tertiary industry and investment in R&D and technical innovation, which is very helpful for China to enhance the internal momentum and activity of economic development. Based on their advantages in efficiency and innovation, private enterprises should take the lead actively in exploring new ways for development which will greatly accelerate the pace of transformation of China's economic development pattern and strategic adjustments of economic structure. In the distant future, promoting the innovative development of the private sector should act as the key for China to resolving contradictions in the economic structure and many other strategic problems regarding development.

V. Suggestion and Conclusion

Although there are still many factors limiting the development of the private sector and private enterprises are not as mature as analyzed above, the private sector has become one of the most important parts of China's socialist market economy, its most dynamic market actor, the main source of domestic economic momentum and vitality. As long as ideas on socialist market economy can be freed up further, policies in support can become more practical and stronger, and favorable environment for development can be created. Thus the private sector will release greater energy, shoulder its mission over time, and gradually take on the historical responsibility of the development pattern transformation.

(1) Emphasize Private Enterprises from Long-term Strategic View

As the history of reform and opening up has proved, the private sector in China is an important driving force in promoting the modernization and economic and social development, and is of strategic importance in resolving contradictions regarding the economy and social structure, and effecting changes in the development pattern. China must liberalize further and revamp traditional thinking about private enterprises. This means paying greater attention to healthy development from a long-term strategic perspective. In accordance with the constitution, laws and regulations, including documents on the "36 articles" and "new 36 articles," the government and the whole society should fulfill, with greater determination and courage, the supporting policies and measures to fully to accelerate the development of the private sector.

(2) Reform the Socialist Market Economy System

The core operating rule of the modern market economy is that the government

regulates the market, and then the market guides enterprises to operate efficiently. China's extensive growth pattern largely derives from the imperfect market economy system which was recently reformed from a highly controlled economy. In a perfect market economy, the market price in China reflect the scarcity of the products and the relationship between the supply and the demand, so enterprises can decide the input structure, product structure and production methods independently, based on the market price. Furthermore, private enterprises are much more sensitive and responsive to market price signals. But in China, unfortunately, the price of various factors such as capital, technology, land, labor, energy, resource and environment etc, is distorted by all kinds of factors which obstruct or limit the market mechanism, which is misleading with respect to enterprises' decision-making, along with production input structure and development patterns. Therefore, at present, the most important thing is to accelerate the progress of reform of the socialist market economy. Especially, the reform of the mechanism of factor price formation which forms the core of the present economic reform must be pushed harder, since it is not only an important strategic mission of national development and reform, but also the necessary premise for China in transforming its development pattern.

(3) Optimize the Development Environments for Private Economy

The private portion of China's economy has been growing step by step, against the small breaches left by state-owned and foreign capital economy, and even until to now, there still exist policy restrictions and extensive market extrusions that represent a serious constraint to the private enterprises. At present, the supporting policies, the "36 articles" or "new 36 articles", just opened up new industry sectors and specified the sectors that private enterprises can enter into. However, such a policy not only leads to high cost of implementation, it would result in serious, difficult-to-resolve problems related to practical operations. There

is also the risk of policy falling steadily behind, as they cannot be revised in timely fashion and can never keep up with the ever changing practices. Therefore, there should be a new thinking with respect to policy, such as specific regulations on which sectors private enterprises can enter, and other areas that all companies can enter, no matter the type. The principle of “all are allowed except that are prohibited explicitly” and “to break the monopoly of the market” should be adhered to strictly by all enterprises, the society in general and the government, in order to resolve the “glass door” and “spring door” problems the private enterprises have been facing for a long time. In order to create larger market space for the vast private enterprises, the market monopoly of many nonessential industries by the large state-owned enterprises should be broken completely and the strategic adjustment of state-owned economies should be accelerated dramatically.

(4) Promote Private Enterprise Develop in an Innovative Way

After over 30 years of development since the reform and opening, in the next period, private enterprises will enter a new stage: of differentiation and reorganization which will create many new large business groups. The private economy is facing a golden opportunity to achieve new life and development under the guidance of more scientific views on development. If the early 30 years of private economy represent the first stage of growth which relies mainly on the promotion of reform and opening policy, with rapid development as the core issue; from now on, the private economy is entering the second stage of transformation which will lean heavily on technical innovation, management innovation and organizational reforms and the core issue will be to transform the development pattern and raise the comprehensive competitive competence. In future, the rational guidance and supervision of private enterprises should be stressed, the social credit system should be strengthened and the credit mechanism construction bolstered. The government and public institutions should guide private enterprises to carry

out technological innovation, improve the management standards, comply with safety rules, and accelerate the establishment of a modern company system, and encourage private enterprises enter the strategic new industries such as new energy, new materials, information technology, biotechnology and other new emerging industries and strive to create new competitive advantage through various measures such as finance and taxation policy, R&D support, staff policy, business mergers and so on.

In one word, China's private economy is much stronger than ever and becoming more important, especially in a new era of national transformation, and has become the most important part of the whole national economy and played a great role in the ongoing process of change. In the future, the strategic position of private economy will become more and more crucial in reforming the whole nation, and in order to transform into a modern high-income economy and society, China should take greater emphasis on the private economy and promote for a more robust development.

References

- Chen Ying. 2005. "Review on the regional economy progress phase theory." *Searching* (2).
- Dong Run. 2010. "Why is economic development mode difficult to change." *Industry Auditing and Accounting* (3).
- National Bureau of Statistics. PRC. 2009. *60 Years of New China*, Chinese Statistics Press (Sep.)
- Hu Jiayong. 2004. "International comparison of the scale of state-owned economy." *Economic Review* (8).
- Hu Yuyue. 2010. "Support the development of private economy in order to adjust the structure." *Investment in Beijing* (1).

- Li Rupeng. 2010. "Gao Ruwei, Thoughts on non-public economy concept need further update." *Academic Forum* (10).
- Liu Hanyuan. 2010. "30 years of non-public economy: yesterday, today and tomorrow." *Economic World* (6).
- Li Yining. "Understand the role private economy in the national economy." *Chinese Logistics and Procurement* (4).
- Ma Xiaohe. 2011. "Overcome the Middle Income Trap in the structure transformation: international experience and China's challenge." *Rural Economics* (4).
- Ma Xiaohe. 2011. "Understand "pay more attention to the top level design the reform" scientifically." *Macroeconomic Management* (5).
- Wang Yiming. 2008. "Speed up the "three changes" of the economic development mode." *National Economy Management* (5).
- Chinese Business Association. 2011. Chinese Entrepreneur Association, *China's Top 500 Enterprises Development Report 2011*. Beijing: Business Management Publishing House. (Aug.)

Azerbaijan Economy: Diversification in lens of Modernization

Vusal Gasimli¹⁾

Introduction

Today, Azerbaijan is one of the leading economies globally with respect to economic growth indicators. One of the important indicators of development in Azerbaijan is the growth of investment attracted, diversification of the FDI portfolio and modernization. Azerbaijan has an excellent record of working with international technology-based investors, particularly in oil and gas industries. Thanks to strong leadership and sound policy-making in the field of modernization, Azerbaijan has managed to triple its economic potential and to maintain a high pace of development over the past 10 years. A further deepening of the modernization of economy paved the way for sustainable development. This article consists of two chapters: i) Diversification trends and ii) Causality relationship between economic growth and labor productivity.

1) Dr. Vusal Gasimli now works as the Head of Department in the Center for Strategic Studies under the President of the Republic of Azerbaijan.

Chapter 1. Diversification Trends

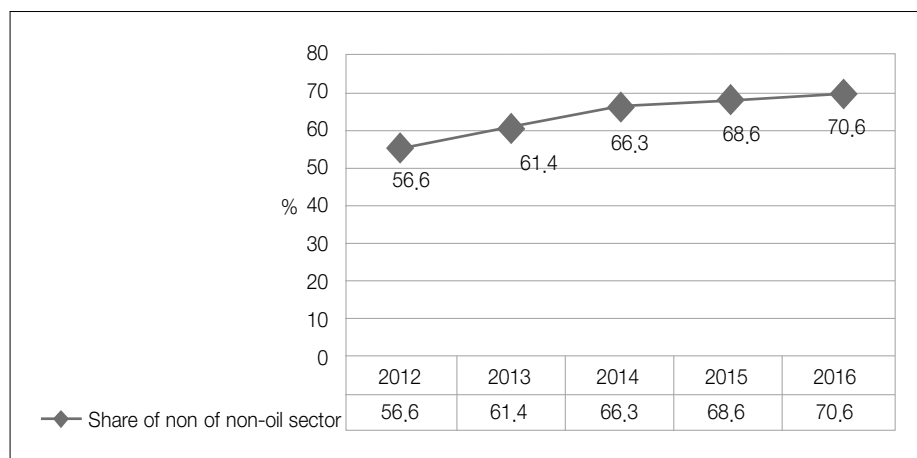
1.1. Introduction

The United Nations definition of *economic diversification*, in its standard usage either in terms of the diversity of economic activities or markets, is a significant issue for many developing countries, as their economies are generally characterized by the lack of diversity. Gelb A. (2010) indicates, that in the 1960's, some 80% of developing country exports were primary commodities; today, almost 80% are industrial products. According to him, this massive transformation in export structure has been associated with the rise of major industrial power-houses; China most prominently, but also countries such as Korea, India, Brazil, Malaysia, Vietnam, Indonesia and Mexico.

Currently, the oil and gas sector dominates the economy of Azerbaijan. In 2012 the oil sector accounted for about 47 percent of GDP, more than 90 percent of total exports, and about 70 percent of state budget revenues. Booming oil prices in recent years helped the country to take advantage of its enormous natural resource wealth. Why does Azerbaijan have to diversify its economy in the first place? Will this lead to its particular comparative advantage? There are two fundamental reasons that justify the digression from the reliance on hydrocarbon resources. First of all, oil prices are very difficult to predict - between 2003-2012, after sharp increases in oil income in Azerbaijan, according to our estimations the coefficient of variation of oil prices has been 0.4 and standard deviation 27.9 US dollar per barrel. Such high volatility makes consideration of diversification inevitable. Even if oil prices are stable, the mere forecasts of decrease in oil production would be enough for a transition to an economy based on non-oil sectors in Azerbaijan. Revenue from oil will start declining permanently in 2016. On the other hand, diversified economies perform better over the long-run. Diversification is not simply a 'good idea' in an oil-rich country like Azerbaijan, but it is also a new reality linked to modernization.

Diversification of economy has five aspects in Azerbaijan: diversification of GDP mainly focusing on non-oil sectors, diversification of exports by upgrading

Figure 1. The share of non-oil sector in GDP in Azerbaijan



Source: Ministry of Finance of the Republic of Azerbaijan.

the share of the innovation-led goods and services, diversification of partners relying on developed economies; diversification of institutional endowments including natural capital, physical capital, human capital and institutional capital; and diversification of economy over the regions.

1.2. Diversification of goods and services

The share of oil and gas sector in the economy decreased from 54.7 percent in 2008 to 49.7 percent in 2011. In the first place, the social and other service activities have filled in the vacuum after the oil and gas sector became more subdued. Between 2008 and 2011, construction increased its share by 1.3 percent, strengthening its position as the 3rd largest sector after oil-gas and social services. During the stated time period, sectors like non-oil industry, trade, ICT, accommodations and public catering improved their share in GDP.

The objective of the economic policy carried out in Azerbaijan for diversification

Table 1. GDP by kinds of economic activity (in percent)

Sectors	2008	2009	2010	2011
Agriculture, forestry and fishing	5,6	6,1	5,5	5,5
Oil and gas	54,7	44,8	47,6	49,7
Non-oil industry	3,8	4,3	4,1	4,2
Construction	7	7,2	8,1	8,3
Trade; repair of transport modes	5,5	6,7	6,4	6,5
Transport and storage	5,2	6,8	5,6	4,9
Accommodation and public catering	0,7	1	1	1,2
Information and communication	1,6	1,9	1,9	1,7
Social and other service activities	9,2	13,3	13	12
Net taxes	6,7	7,9	6,8	6

Source: State Statistical Committee of Azerbaijan.

is to increase the share of non-oil sector in GDP to more than 70 percent by 2016.

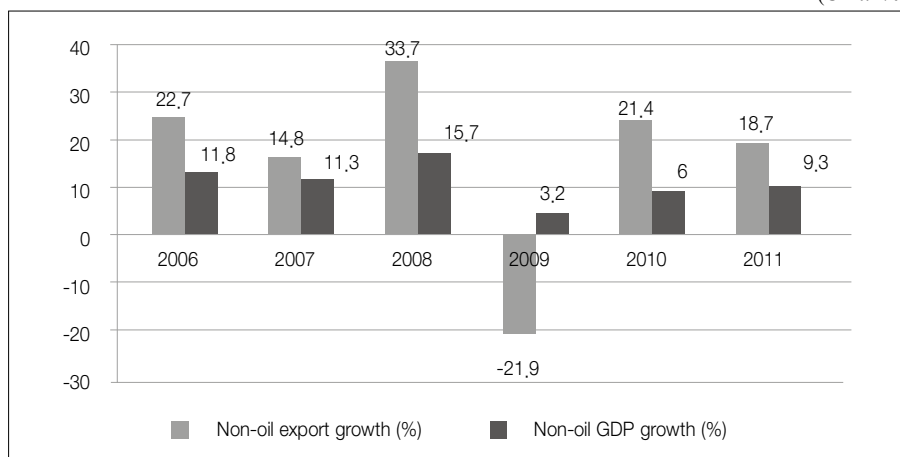
1.3. Export Diversification

There are plenty of studies that prove the plausibility of the hypothesis linking export diversification and growth. The growth rate of the non-oil exports is outpacing the growth rate of the non-oil sector in Azerbaijan. It proves the pro-export nature of non-oil development. Although non-oil exports increased by 2.1 times between 2005 and 2011, export diversification remains a challenge. As hydrocarbons consist of more than 90 percent of Azerbaijan's exports, the concentration ratio of exports is very high in Azerbaijan. Since the State Oil Company of Azerbaijan (SOCAR) and Azerbaijan International Oil Consortium (AIOC) are the main exporters, the Herfindahl-Hirschman Index indicates high market concentration in Azerbaijan. Thus export diversification will lead Azerbaijan to perfect competition as well.

The success stories among East Asian "Tigers" evidence export promotion and

Figure 2. The comparison of the non-oil export and GDP growth in Azerbaijan

(Unit: %)



Source: State Statistical Committee of Azerbaijan.

outward orientation. In these countries, diversification efforts capitalized on the abundant labor supply and were based on the export of high volume manufactures. Since Azerbaijan is heavily dependent on oil exports, a key challenge is to avoid dependence on oil in export revenues and stabilize export earnings. Toward this end, Azerbaijan can draw lessons from the experience of China, India and other East Asian “Tigers”. Samen S. A. (2010) considers that the success story of high-performing Asian economies that experienced substantial increases in exports, and especially exports of manufactures goods and high growth rates of their GDP over many decades, has prompted many analysts to view export development and diversification as the new engine of growth, because export diversification is associated with long-run growth and technology spillovers that raise productivity and income. The focus on exports was a common characteristic in countries that have diversified successfully. Azerbaijan strives to the sustainable long term export growth in the level of horizontal (e.g. adding new petrochemical products on existing oil and gas dominance), and vertical (e.g. move from raw oil and gas to higher

value added industrial products and services) diversification.

Another approach directed toward export diversification grounded on foreign markets is broken into a) traditional markets (such as the CIS); b) developing markets (such as Turkey) and c) developed markets (such as the EU, USA, and Canada). Greater diversification of trading partners would help reduce emerging economies' vulnerability to slowdowns in specific trading partners (IMF).

A successful foreign trade policy pursued over the recent years created an opportunity for the export of goods from Azerbaijan to developed countries on privileged terms. Thus, the Republic of Azerbaijan, which enjoys Generalized Systems of Preferences (GSP) with Canada, Japan, Norway, and Switzerland, were included in the GSP+ program of the EU and GSP program of the US in December, 2008.

1.4. Diversification in terms of finance

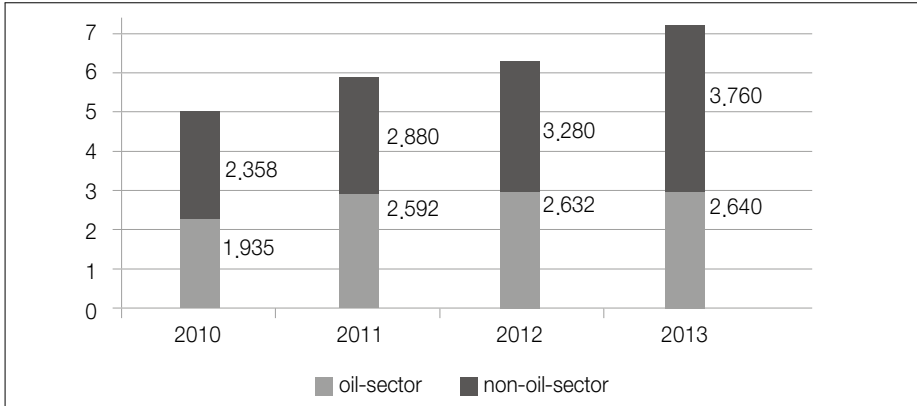
One of indicators of the diversification in the Azerbaijani economy is the evidence of increasing amount of taxes from the non-oil sector. Non-oil sector tax revenues in the Azerbaijani state budget will rise by 15 percent in 2013. The non-oil sector will ensure a transfer of 3,760 million AZN to the state budget, which exceeds the same figure by 59 percent in 2011.

70 percent of investments, in other words USD 12.6 billion out of USD 18 billion will be directed to the non-oil sector in 2013. Refining industry, construction, trade and services are receiving sufficient financing by commercial banks of Azerbaijan.

Government of Azerbaijan actively supports the private sector with the assistance of the National Fund for Entrepreneurship Support. About USD 270 million in preferential credits were granted by the fund to more than 2,327 investment projects in 2012. Directions of use of the finance of the National Fund for Entrepreneurship Support (NFES) coincide with the purpose of the government for economic diversification. Thus funds from NFES mainly stream to the production

Figure 3. Budget revenue in line with the Ministry of Taxes

(Unit: million AZN)

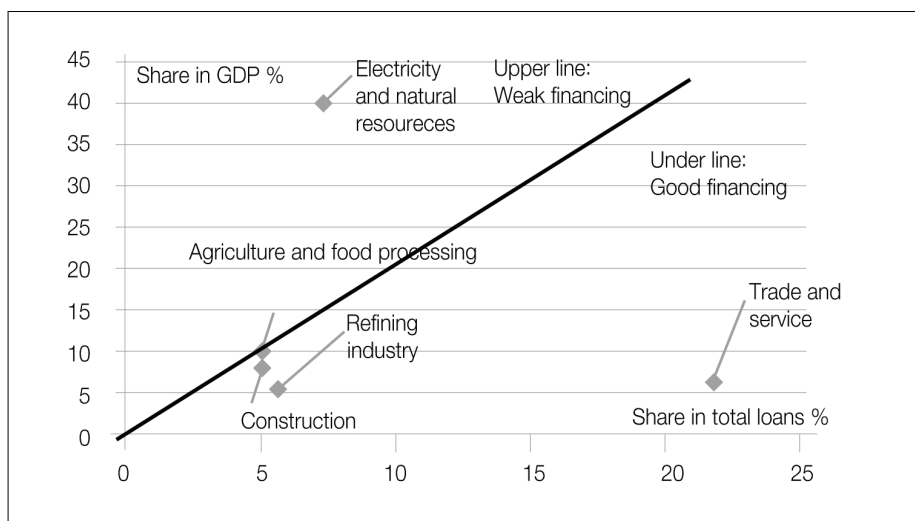


Source: Ministry of Finance of Azerbaijan.

of agricultural products, production of competitive and export-oriented food and other industrial products with usage of modern technologies and establishment of modern cold storage complex. In this way, the government supports development of small and medium entrepreneurship in regions.

The Government of Azerbaijan strives to push economy forward based on innovation, creativity and high value sources of growth, such as types of services (tourism, transport, logistics etc.) in which Azerbaijan has strong advantages. As a land-locked country, Azerbaijan needs to develop fields, like services which are not subject to the trade barriers that physical exports have to overcome. The services sector assumes an increasing share of GDP as the economy matures, as is evident in the case of developed countries. There is even a success story in the case of an emerging economy like India that proves that industrialization is not the only reasonable way to rapid economic development. For example, unlike China, India relies on service sector in its booming economy. Azerbaijan strives towards to become a developed country, so there will be greater focus on the development of the services sector, along with some non-oil manufacturing sectors. Thus investment in service

Figure 4. Comparison of percentages of sectors in loans and GDP (2000-2009)

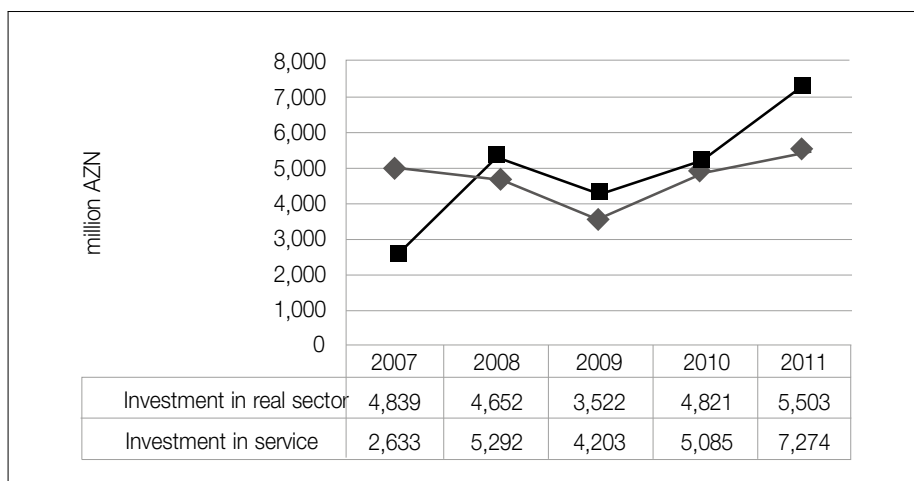


sector outpaces other fields. Investments in the services sector in 2011 totaled 7.3 billion AZN in Azerbaijan. Therefore, service sector becomes the prime engine of non-oil growth.

In future, in order to serve the diversification of the economy, investments should be partially driven by the private sector and focus on small-scale support along with large-scale “white elephant” projects. By diversifying investments Azerbaijan might reduce the likelihood of any single investment having a major influence on the portfolio. Investing in different types of assets will protect the economy against significant loss.

Azerbaijan might extract a useful lesson from the South Korean experience between 1950s and 1980s. Chung Y. (2007) shows that investment in South Korea was carried out by both the public and private sectors but, unlike the situation in many developed economies of the West, the volume of public investment in the country has been relatively large and the government has played an active, positive and critical role in the nation’s investment. Like its neighboring northeast Asian

Figure 5. Investment in fixed capital in Azerbaijan



Source: State Statistical Committee of Azerbaijan.

countries, the South Korean government did not hesitate to use public enterprises, the most direct instrument of intervention, as a way to direct the nation's resources toward investment. In the early years, the government believed that it was essential to invest in public enterprises and operate them itself, since capital-poor private entrepreneurs lacked the wherewithal or expertise, or both, as well as the experience, to launch the critical industries thought to be necessary for economic growth and the nation's well-being. From the perspective of *capital budgeting*, public expenditures increase public assets. The government reserves the option of being able to privatize some of its assets in the future. In other words, the government build assets, then operate and transfer it to the private sector.

According to Chung Y. (2007) one of the most conspicuous development in investment in South Korea after the Korean War was not only the skewed investment pattern toward the modern and industrial sectors but also the heavy emphasis on capital- and technologically intensive industries over time.

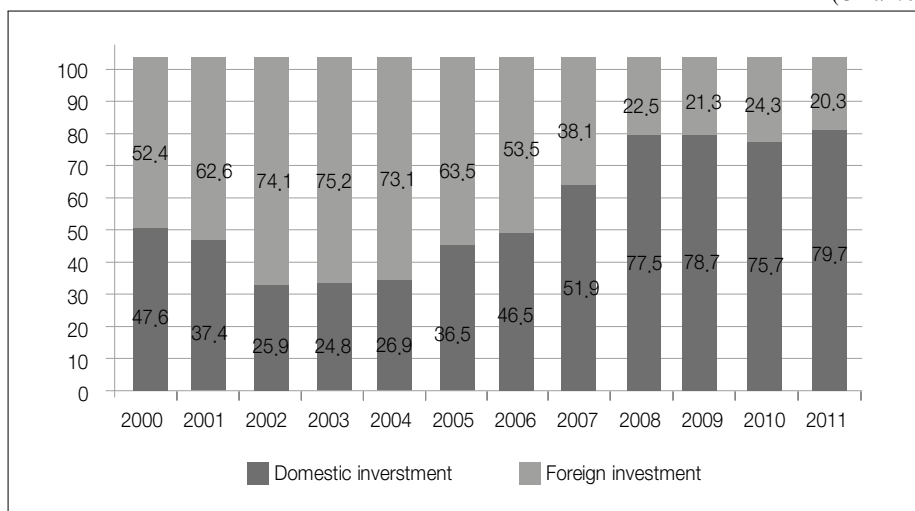
Like South Korea at the first stage of its economic rise, the initial orientation in Azerbaijan was investment in labor-intensive fields, in which Azerbaijan has competitive advantages. But, when the low-value-added and labor-intensive industrial structure faced increasing competition, economy reacted to the problem by investing in high-value-added and capital-intensive industries in the non-oil sector. On the other hand, openness to technologically intensive FDI in the field of oil and gas empowered export growth and mechanism for technological upgrading. Thus Baku, the capital of Azerbaijan, has kept its status as the Oil Academy.

1.5. The Role of Foreign Investment in the Modernization Process

The chapter explores the implications of the recent rise of Azerbaijan as an important destination for foreign direct investment (FDI) and the role of foreign capital in the diversification and modernization of its economy. Azerbaijan is one of the largest recipients of FDI in the Eastern Europe and CIS regions due to resource-seeking investment inflows, especially to the oil industry. Having attracted transnational oil companies to the Caspian, Azerbaijan not only opened its economy to the world, but it managed to become a driver of integration in this region to the world economy. Along with oil sector, the privatization in the non-oil sector in the 1990s attracted a substantial amount of foreign investment to Azerbaijan. Deregulation and privatization enforced private ownership, FDI attraction and free competition leading to restructuring of the national economy. As the Government of Azerbaijan provided guarantees against deterioration of legislation, against nationalization and requisition, compensation of damages and profit repatriation foreign investors feel confident in Azerbaijan. "Not less favored" than local investors foreign companies can freely compete in the domestic market.

Fitch Ratings has affirmed Azerbaijan's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BBB-' in 2012. This rating signifies that Azerbaijan stands at the same level with European countries like Bulgaria, Croatia and Romania, and ahead of Hungary, Turkey, Serbia, Portugal, Macedonia, etc. Azerbaijan's credit

Figure 6. Investment directed by internal and external sources to fixed capital in Azerbaijan
(Unit: %)



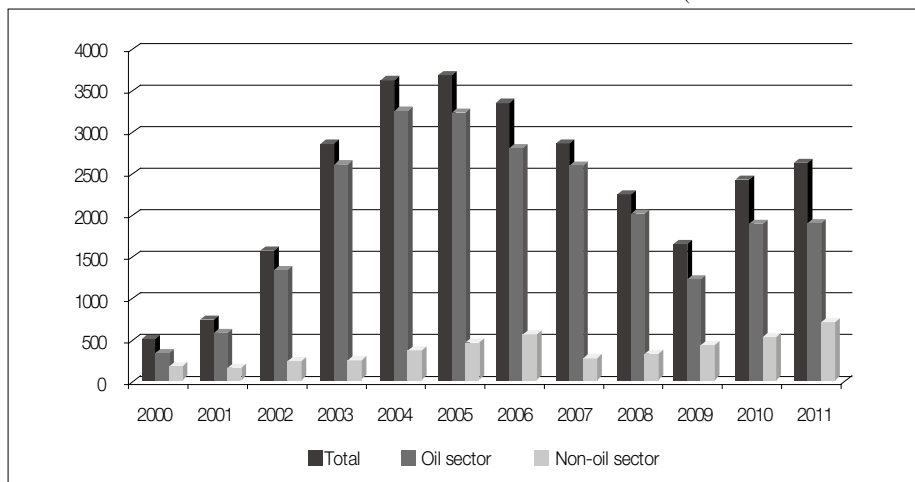
Source: State Statistical Committee of Azerbaijan.

rating from Fitch Ratings corresponds to those of BRICS countries. Since credit rating reflects the country's fiscal and economic soundness, it could be accepted as a stimulus for foreign investors to invest in Azerbaijan. Other credit agencies, like Standard & Poor's and Moody's, share the same view toward Azerbaijan. For example, Moody's Investors Service upgraded Azerbaijan's foreign- and local-currency government issuer ratings by one notch to Baa3 from Ba1 in 2012. Moody's took into consideration in its rating the strong performance of Azerbaijan's non-oil sector in recent years as a result of government investment activities, as well as efforts to improve the business environment and diversify the economy away from the oil sector.

Between 2000 and 2011 total foreign investments to fixed capital amounted to USD 28 billion in Azerbaijan. FDI influx has been playing a significant role in allowing Azerbaijan gain dynamic capacity and international competitiveness. Toward this end, Azerbaijan became one of the fastest growing economies in the

Figure 7. Comparison of FDI in oil and non-oil sectors in Azerbaijan

(Unit: million US dollar)



Source: State Statistical Committee of Azerbaijan.

world over the last decade. As *Narula R. (2005)* considers developing countries that have switched reluctantly from inward-looking strategies with a large role for the government to market-friendly strategies to attract FDI that forces them to face a new multilateral milieu, one in which they have little experience and with which they are often poorly prepared to cope. So the Government of Azerbaijan provided institutional and legislative reforms to absorb FDI in demanded volume.

First wave of investment inflows to Azerbaijan were resource-seeking types, but now it has switched to market-seeking and efficiency-seeking investments. Predominance of FDI inflow to the oil sector is gradually lessening. While global crises obliged investors to tighten belts, Azerbaijan has managed to effect an upsurge the volume of FDI since 2010. After several years of an upward FDI trend, the inflows declined between 2006-2009 years in Azerbaijan. But a diminishing trend was observed because of adjustment regarding the investment schedule in the oil sector. As a matter of fact domestic investment, mainly by public investment, compensated for the increasing gap. The share of FDI in the non-oil sector is being

increased (Figure). At this end, increasing amount of FDI in non-oil sector supports diversification and modernization of economy of Azerbaijan.

Azerbaijan stored FDI per capita of about 500 USD through year-end 2012. This is more than twice the CIS average and is about the same range of Central Europe.

During the period from 1995 to 2011, more than 60%, i.e. about 63 billion US dollar from 119 billion US dollar of investment directed to the economy of the country was foreign investments (Investment climate in Azerbaijan). The volume of the foreign investments in the period 1995-2002 has been 9 billion US dollar, and this figure has increased 6 times in 2003-2011 and reached 54 billion US dollars. But only 25.5 billion dollars directed at the economy of the country during 1995-2011 went to the non-oil sector, whereas 37.5 billion dollars were for the oil sector.

Over USD19.5 billion were invested for the development of the economic and social sectors in Azerbaijan in 2012, or 18 percent more than in the same period for 2011 (Trend). Around 21.2 percent or USD 4.1 billion out of the total volume were accounted for by foreign investment. According to the State Statistical Committee of Azerbaijan during 2012 year following installations were put into operation with the participation of foreign investment: Metal Constructions Plant, Assortment and Burning of Solid Waste Plant, “Baku Crystall Hall” Sport-Concert Complex, “Caucasus Baku City Hotel and residences” and “JW Marriott Absheron”, “Four Seasons” hotels, a solid waste sorting factory and incineration plant and etc. The variety of new enterprises proves the practical importance foreign investments in deepening diversification and modernization of the Azerbaijani economy.

The top two countries, USA and UK count for more than half of all foreign investments to fixed capital (Table 2) due to their significant role in hydrocarbon-related activities in Azerbaijan.

Table 2. Foreign investments to fixed capital by countries in Azerbaijan

Countries	2005		2006		2007		2008		2009		2010		2011	
	million AZN	%	million AZN	%	million AZN	%	million AZN	%	million AZN	%	million AZN	%	million AZN	%
Total investment	3665.0	100	3333.1	100	2844.5	100	2,242.0	100	1645.0	100	2406	100	2600.1	100
UK	1884.7	51.4	1547.7	46.4	1222.6	43	1,025.6	45.8	800.9	48.7	1247.239	51.8	1184.5	45.6
USA	651.3	17.8	574.6	17.2	649.6	22.8	435.1	19.4	301.0	18.3	359.3831	14.9	385.7	14.8
Japan	365.9	10	325.6	9.8	346.7	12.2	225.2	10.1	113.1	6.9	180.1054	7.5	234.4	9
Norway	256.8	7	225.3	6.8	213.1	7.5	139.0	6.2	70.5	4.3	111.8662	4.7	131.0	5
Turkey	210.6	5.8	215.3	6.5	168.0	5.9	147.3	6.6	55.9	3.4	95.0295	4	106.3	4.1
Germany	88.6	2.4	214.4	6.4	36.0	1.3	30.1	1.3	0.3	0	0.7	0	5.9	0.2
S.Arabia	81.9	2.2	69.1	2.1	3.7	0.1	4.1	0.2	2.5	0.2	4.268	0.2	2.7	0.1
Israel		-	41.5	1.3	-	-	-	-	-	-	-	-	-	-
France	17.1	0.5	19.6	0.6	13.3	0.5	27.6	1.2	40.0	2.5	29.451	1.2	45.9	1.8

Source: State Statistical Committee of Azerbaijan.

1.5. Conclusion

Over the past ten years Azerbaijan has witnessed unprecedented economic growth. While many European countries are in crises, Azerbaijan's economy is growing at an enviable pace. Oil income has been used to modernize infrastructure, diversify the economy and improve social well-being. Recently, construction and service sectors grew at higher rates, reshaping the current structure of the economy. Fiscal expansion has been the leverage to keep economic growth, as well as diversification, while monetary policy stands ready to ensure stability of national currency and manage inflation. But non-oil primary deficit and expected decreases in oil production after 2016 obliged Azerbaijan to accelerate the diversification of its economy. Azerbaijan has done well through the global economic crisis, but the question is that whether this strong performance will last. Thus a well-sequenced reform strategy should synchronize the development level of hardware (infrastructure) and software (business climate) of the economy to contribute modernization and

diversification in Azerbaijan.

Resource-rich countries, like Chile, Indonesia and Malaysia have done well in terms of diversification, but are having difficulties in escaping the middle-income trap. To some extent their achievements, the attainment of developed manufacturing and service sectors, could be a formula for success for Azerbaijan. After Malaysia, Azerbaijan is striving to become the second predominantly Muslim and resource-rich country which has succeeded through something other than the utilization of natural resources. Arip *et. al.* (2000) argue that, in order to sustain future economic growth under the static effect of multilateral and regional trade liberalization, Malaysia should diversify its export commodities and develop greater social and economic cooperation with the rest of the world. As an export-oriented economy, in the long run, this strategy could help stabilize Malaysia's export earnings

At the same time Azerbaijan should look forward to countries which passed the threshold to become high-income economies, like South Korea. There are many explanations for the rapid growth and structural changes in South Korea after the Korean War. Chung Y. (2007) argues that among them are the people's will to develop the nation's economy; Confucianism and the extended family system; the existence and speedy establishment of the crucial institutional reform suitable for investment and economic development; the high-quality and adaptive labor force with low wages; and the positive role of a strong, stable, and able government.

Prophet Joseph had been gathering wheat when Egypt had faced seven years of prosperity and then used these reserves when the country suffered seven years of starvation. It is historical example, how fairly natural endowment should be distributed between generations for sustainable development. Based on the permanent oil income hypothesis the IMF suggests to Azerbaijan, even if oil prices turn out to be higher than budgeted, additional oil fund resources should not be used to increase government spending given (i) the available room to improve the quality and efficiency of spending, and (ii) the need to significantly reduce the non-oil deficit to secure medium-term fiscal sustainability. But the other side of this coin is the demand for modernization of infrastructure which would lead to diversification.

Capital intensity - the term for the amount of fixed capital present in relation to labor - in Azerbaijan lags behind developed countries. Azerbaijan is well on its way to reaching the Golden Rule capital-labor ratio that maximizes consumption per worker in a steady state. Thus the common denominator must be found to achieve comprise between two points of views based on filling the gap in the non-oil deficit and capital stock raise.

The Government of Azerbaijan should design a diversification strategy relevant to the concept paper entitled "Azerbaijan 2020: The Vision into the Future". Diversification strategy may cover institutional reforms for enabling good governance fostering modernization of the economy, and sector-specific support and policy for the improvement of infrastructure.

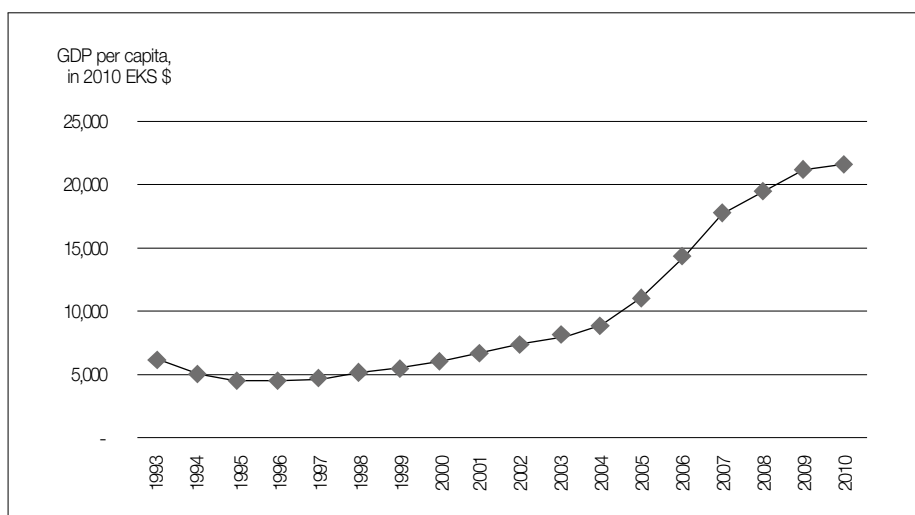
Chapter 2. Causality Relationship between Economic Growth and Labor Productivity

2.1. Introduction

Labor productivity and modernization of the economy are complementary issues. A strong causal link exists between rapid economic growth and labor productivity in Azerbaijan. By itself, more rapid labor productivity growth contributes to faster output growth. At the same time, stronger productivity gains let businesses increase output without adding workers. Zandweghe W.V. (2010) believes that faster productivity growth contributed to "jobless recoveries" after the 1990-91 and 2001 recessions.

Recently Azerbaijan became the country with the fastest labor productivity growth in the world (Conference Board Total Economy Database Output and ILO). Labor productivity grew at an average annual rate of 13.6 per cent over the period of 2000-2010 (ILO). While OECD countries saw a gradual decline in labor productivity growth between 2004 and 2009, with the worst years of the crisis coming

Picture 5. The dynamics of consumer price index for goods and paid services for the public in CIS-countries (2012 in % by December 2011)



Source: The Conference Board Total Economy Database, Output, Labor and Labor Productivity Country Details, 1950-2010.

in 2008 and 2009, experiencing contractions of 0.1% and 0.3% respectively (Global Finance). Azerbaijan has increased labor productivity by producing more output per hour worked rather than by increasing the total hours worked. After a full decade of high productivity growth in 2000-2010, we observe a slowdown of productivity growth in 2011 following the contraction of the oil industry in Azerbaijan. The other reason behind the slowdown might be “skill-biased technical change”. The fast ICT penetration across industry makes labor force more substitutable and sensitive to technological shocks in Azerbaijan. Gordon R.J. (2010) argues that the ICT revolution has both increased the flexibility of labor markets and provided firms with new tools to boost productivity during economic recoveries as they continue to cut labor costs.

The World Bank’s Knowledge Economy Index (KEI) Report (2012) indicates that Azerbaijan with a current KEI of 4.56, has moved up 15 spots since 2000

to rank 79th in the world in 2012. Its ICT pillar rose by an impressive 26 places, thanks to the strong growth of Internet users. However, the Economic Incentive and Institutional Regime (EIR) is Azerbaijan's weakest pillar primarily because of its relatively weak rule of law and regulatory quality. Out of 15 post-Soviet republics, Azerbaijan made the most progress in terms of Knowledge Economy Index since 2000.

Education is decisive for the growth of labor productivity in Azerbaijan. Just as South Korea has experienced, investment in labor force might allow Azerbaijan to become an emerging Knowledge Economy powerhouse. Once a country attains at certain literacy rate, it can increase growth by opening its economy to technology transfer, as Costa Rica has done due to its well-educated labor force. Azerbaijan's literacy rate is nearly 100 percent, which is one of the highest in the world (IndexMundi). The Government of Azerbaijan has shown a long-term commitment to developing a modern and qualified labor force. The State Statistical Committee of the Republic of Azerbaijan indicates that the number of officials and specialists that received special education doubled in the period 2000-2010. During that time period the number of graduates from the public higher educational institutions tripled in Azerbaijan. Both public and private sectors are proactive in adapting the latest technologies and on-the-job-training opportunities. Estimates suggest that changes in educational attainment—as opposed to the initial level of education used in most of the macroeconomic growth literature—affect cross-country income growth at least as much as they affect microeconomic estimates of the private rate of return to years of schooling (World Bank).

Azerbaijan ranks 26th in “labor market efficiency” out of 144 countries, according to the Global Competitiveness Report 2012-2013. So we observe an upward assessment of labor market efficiency and it is considered one of drivers of productivity and prosperity in the Azerbaijani economy. Some aspects of the labor market lend themselves to efficiency, such as flexibility of wage determination (29th), hiring and firing practices (4th), pay and productivity (20th) and a high female participation in the labor force (21th). Structural preferences in the labor market

Table 3. Labor market efficiency in Azerbaijan

	Indicator	Value	Rank/144
1	Cooperation in labor-employer relations	4.7	37
2	Flexibility of wage determination	5.4	29
3	Hiring and firing practices	5.4	4
4	Redundancy costs, weeks of salary	22	96
5	Pay and productivity	4.6	20
6	Reliance on professional management	3.8	102
7	Brain drain	3.4	70
8	Women in labor force, ratio to men	0.92	21

Source: The Global Competitiveness Report 2012 - 2013, World Economic Forum.

prompts businesses to modify the way they meet their labor needs, and motivates firms to adjust labor inputs more aggressively.

Casual observation shows that labor productivity has behaved differently in various sectors of manufacture in Azerbaijan. The highest level of labor productivity is in industry, while the agriculture suffers from a low rate of labor productivity.

In Azerbaijan, labor productivity is highly supportive of business activity and output growth, combined with flexible labor markets and the stable macroeconomic environment, continue to make the Azerbaijani economy very competitive. In this chapter we will analyze the interrelationship between labor productivity and output based on Verdoorn–Kaldor law.

2.2. Literature review

Verdoorn (1995) and Kaldor (1966) described the relationship between the growth of output and the growth of productivity; in other words, in the long run a change in the volume of production transfers increases in labor productivity.

Verdoorn (1949) in his well-known article notes that increases in the volume of production impacts the division of labour, and for that reason the growth of production creates the possibility of further rationalization. Although Verdoorn himself never spelled out this link, Rowthorn (1979) implied the following linear relationship according to Verdoorn's law:

$$p = \frac{\mu}{1 + \rho} + \frac{\rho}{1 + \rho} q$$

where p is the growth rate of industrial productivity, q is the output growth, μ and ρ are constants. Thus, implicit in Verdoorn's model is a linear relationship between p and q which is determined by the conditions of labour supply and is independent of the technology of production. Verdoorn call the ratio of p to q , as the "elasticity" of productivity with respect to output. In the abovementioned article using data from a number of different countries Verdoorn discovers that a 10% growth of output causes labour productivity to increase by 5.73%.

In its turn Nicolas Kaldor, one of the foremost Cambridge economists, had his own approach on Verdoorn's law. He emphasizes that the growth of effective demand motivates product and process innovations and therefore lead to increases in labour productivity. Looking at dynamic nature of increasing returns to scale, he considers that economies of scale will depend on the structure of industry. Above mentioned idea was covered in Kaldor's research entitled "Causes of the Slow Rate of Economic Growth of the United Kingdom" in 1966. Castiglione (2011) indicates that since Kaldor's seminal work in 1966 the relationship between the growth of output and the growth of productivity has been renamed Verdoorn-Kaldor's law. Therefore, Verdoorn-Kaldor's law could be defined as below: an increase in the rate of manufacturing output leads to labor productivity in that sector.

Having analyzed Verdoorn-Kaldor's law, Mamgain (1999) concludes that high rates of the growth manufacturing do not translate into high productivity levels in Singapore, Indonesia, Thailand and Mauritius, but they do so in South Korea.

According to him, the experience of new industrializing countries makes Verdoorn–Kaldor’s law disputable. Meanwhile, Knell (2004) believes that the Kaldor-Verdoorn law continues to be strong and robust in the 1990s. In his paper, Knell examines and reassesses the Kaldor-Verdoorn law during the 1990s in ten countries of the European Union (EU), the United States and Japan as well as seven Eastern European countries that had applied for membership in the EU at that time. Hamalainen *et al.* (1995) confirmed Verdoorn–Kaldor’s law for Denmark, Finland, Norway and Sweden.

We can cite plenty of scholars who made attempts to model growth, starting with Adam Smith and all the way to Robert Solow. For example, Solow explains growth in income per capita by increase in capital per worker and the technological change. But considering the entire population in the labor force is disadvantage of Solow Growth Model. Only population of working age is essential.

To this end Romer’s approach is quite close to Verdoorn-Kaldor’s law. Romer (1989) considers that in addition to the usual relationships between the rates of change of inputs and outputs suggested by growth accounting, there will be a role for the level of human capital variables in explaining the rate of growth of output and the rate of investment.

Having analyzed the Kaldor’s Inaugural Lecture on UK’s slow growth rate in 1966, Thirlwall (1983) justifies Kaldor’s approach by stating that manufacturing is the engine of the growth. But later superior growth of service sector over the world demands a new approach to Verdoorn-Kaldor’s law.

2.3. Empirical estimations

The most recent work, which this study follows in part, is by Castiglione (2011) who formulated Verdoorn’s law in terms of cointegration and Granger causality. Following the Granger causality test (1969) methodology, the direction of causality for determining whether one time series is useful in forecasting another will be detected by using the error-correction model.

Manufacturing output is shown by the Azerbaijan State Statistical Committee. Real output in manufacturing covers industry, construction and agriculture. Year 1993 was accepted as the base year.

Labour productivity is evaluated in terms of the index of additional value per number of employees in manufacturing with the same base year.

We shall check whether these variables of output and labor productivity have unit roots. This is because many econometric models ask for a stationary date. It means that if the variable has a unit root, it cannot be applied; hence it will be our first target in converting these variables to stationary. If the variables are non-stationary, then the test will be done using the first or second differences. The number of lags to be included is chosen using the Schwarz information criterion.

Our first test is the Augmented Dickey Fuller (ADF). To tackle the problem of autocorrelation, Dickey Fuller have developed a test with three shapes: 1) equation with only intercept; 2) equation with trend and intercept; 3) equation which has no trend and no intercept. In this case Null Hypothesis is that the variable is not stationary or has a unit root.

We used ordinary least squares (OLS) to estimate the slope coefficients of the autoregressive model. Because when the stochastic process is non-stationary, the use of OLS can produce invalid estimates. Granger *et al.* (1974) called such estimates “spurious regression” results with no economic meaning.

The alternative hypothesis is that the variable is stationary. When p-value is less than 5% we reject the Null Hypothesis, meaning that particular variable is stationary. If p-value is more than 5%, then we accept the Null Hypothesis, meaning that particular variable is not stationary and has a unit root. While running ADF in order to define lag length we rely on automatic selection by econometric software. As mentioned above, we chose the Schwartz Information Criterion for modeling. Based on this criterion, the software chose a maximum lag length of 5. At the first level, p-value was more than 5%. On the other hand the first level ADF test statistic was less than critical values at the levels of 1%, 5% and 10%. If ADF test statistic was less than critical values, then we accept the Null Hypothesis.

Table 4. Unit roots tests on manufacturing production and labour productivity

Variables	Variables in level			Variables in 1st difference			Variables in 2nd difference		
	ADF	Critical value	p-value	ADF	Critical value	p-value	ADF	Critical value	p-value
Manufacturing production	1.49	-2.71 (1%)	0.96	-1.09	-2.71 (1%)	0.24	-3.44	-2.71 (1%)	0.002
		-1.96 (5%)			-1.96 (5%)			-1.96 (5%)	
Labour productivity	0.98	-2.71 (1%)	0.91	-2.03	-2.71 (1%)	0.43	-4.01	-2.71 (1%)	0.005
		-1.96 (5%)			-1.96 (5%)			-1.96 (5%)	

In order to accept the Augmented Dickey Fuller Test Equation, the coefficient of the variable should be negative.

We run all three forms of ADF (intercept only; trend and intercept; neither trend nor intercept) at the first level and found out the non-stationary nature of the variable, in other words the variable has a unit root. To make the variable stationary, we went for the first difference. The result was the same: the variable had a unit root at the first difference. Only in the second difference p-value, did ADF test statistic and coefficient proved that the variable has no unit root and it is stationary. Thus it is possible to conclude that variables are both integrated at order 2.

In order to study the cointegration, the Engle-Granger stationarity test on the residuals calculated on the Verdoorn-Kaldor law. Although this approach has been criticized in a number of articles, it is one of simpler methods of studying cointegration. The Engle-Granger methodology is based on the whether residuals can remain stationary. First of all we run the OLS model covering both variables: output and labor productivity. Then we compile a series of residuals in order to find out whether it is stationary or not. So we need to test residuals for unit roots. If residuals series are stationary, then variables are cointegrated. The point here is that, in our case p-value and t-statistics allow us to reject the Null Hypothesis, in other words to say that residuals are stationary. (Here we can compare the t-statistics

against the correct critical values for cointegration test provided by Davidson and MacKinnon. In our sample the value of t-statistics (-3.93) is less than the asymptotic critical values for cointegration test in the levels 1%, 5% and 10%. Therefore Null Hypothesis could be easily rejected: both variables have long running associations, in other words in the long run they move together)

Castiglione (2011) argues that if the variables are both integrated of the same order, it is possible to study the short and the long-run relationship between the logarithms of manufacturing production and the logarithms of labour productivity. Sjo (2011) also considers that if the variables are cointegrating, they will share a common trend and form a stationary relationship in the long run.

Castiglione (2011) suggests that by following methodologies of Granger (1986) and Engle and Granger (1987), the direction of causality between labor productivity and production in the manufacturing sector can be detected by estimating the Error Correction Models (ECM).

Our estimations show that error correction term is -0.33 and p-value equals 0.0177. It gives validity to the variables like output and labor productivity that they have long run equilibrium relationships. Because error correction term has a negative sign and p-value is less than 5%. Since the R-squared (0.91) is less than Durbin-Watson statistic (1.33), ECM in this case is not spurious, in other words, these two variables have direct causal connection and they not wrongly inferred that they do, due to either coincidence or the presence of a certain unseen factor. Breusch-Godfrey Serial Correlation Tests have p-value of 0.167 or more than 5%. So it can be easily proved that our Error Correction Model is not serially correlated. On the other hand residuals are normally distributed.

From our estimations based on Granger Causality, we see that we can reject the null of no causality from labor productivity to output. On the other hand we can reject the null of no causality from output to labor productivity. In summary, we have reasonable evidence for Granger causality from the price of Arabica coffee to the price of Robusta coffee, but not vice versa.

Table 5. Error correction models

	Coefficient	p-value
Beta	-0.33	0.0177

Table 6. Granger causality between labor productivity (lp) and output (p)

Pairwise Granger Causality Tests

Date: 01/15/13 Time: 07:12

Sample: 1993 2011

Lags: 2

Null Hypothesis:	Obs	F-Statistic	Prob.
P does not Granger Cause LP	17	4.90784	0.0277
LP does not Granger Cause P		4.67597	0.0315

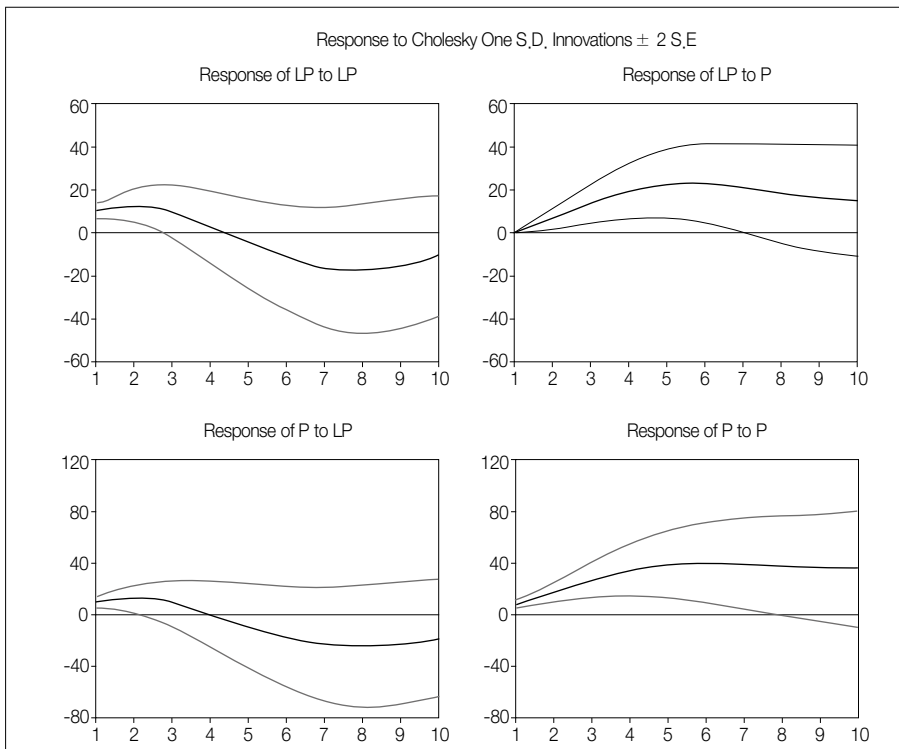
The final step of this analysis is to study the impulse response function (IRF) under VAR environment and find out how output and labor productivity impact each other. First of all we run unrestricted VAR and assume that both variables are endogenous. We give one positive standard deviation shock to check how variables react to each other and in which manner. Table shows that labor productivity will impact on output positively within first 4 years in the future, but afterwards the impact will gain a negative sign. However the impact of output to labor productivity will only be gaining positive signs for the next 10 years. Thus it is possible to assert that manufacturing output and labour productivity variables are cointegrated and a shock in output has a positive influence on the labour productivity. A shock of productivity on itself will be positive. But a shock of labor

productivity on itself is expected to be positive only during the next first 5 years.

2.4. Conclusion

The results confirm that the Verdoorn-Kaldor's law holds in Azerbaijan during the period 1993–2011. However lessons should be drawn from the decreasing trend of the impact of labor productivity on itself and output in future perspective. It proves the importance of the principle of “transferring oil capital to human capital” in Azerbaijan.

Figure 9. Impulse response function



Where, p denotes output and lp denotes labor productivity

Our research shows that the changed cyclical behavior of labor productivity is associated with the changes in manufacturing output in Azerbaijan. Until 2000, changes in output were typically larger than changes in labor productivity. In contrast, since 2000 the growth rate of labor productivity started to outpace those of output. Correlation coefficient between labor productivity and output is 0.77 with a negative sign for the period 1993-1999, meaning the two variables vary in the contrary direction. At that time –first years of independence - firms leaned to cut their labor inputs sharply. A big privatization wave, in the middle of 1990s, brought the private sector into control of majority of small and medium firms. So firing of workers under very tough circumstances was the only way to optimize production.

On the other hand, the correlation coefficient between labor productivity and output is 0.996 for the period 2000-2011, meaning the two variables vary in the same direction. Since both correlation coefficients are close to 1, the two variables are highly related. Since 2003 the Government of Azerbaijan has implemented a new strategy to create new jobs. Matching workers to jobs in different industries and skill requirements was a time-consuming challenge, yet the government of Azerbaijan has managed to create more than 1 million new jobs between 2003 and 2013. Thus, the structural changes in the labor market led to the growth of productivity. As a result, labor productivity can change in the same trend or in the opposite trend of output, depending on the modernization and structural and institutional reforms.

The subsequent analysis explores why the correlation of the labor productivity with output has moved up between 2000 and 2011, compared with the preceding period from 1993 to 1999. Research finds that the relative importance of supply shocks in terms oil windfall to the business cycle pushed labor productivity forward in the period 2000-2011, because the oil and gas industry was reshuffled completely, using high technology. In its turn, the modernization of oil and gas industry geared up labor productivity. (At the same time oil and gas sector had spillover effect on others to push productivity forward) So modernization, like gears, is a mechanical process not unlike gears that transmits motion by means of successively engaging

teeth, between labor productivity and output. Kydland *et. al.* (1982) considers that random fluctuations in the productivity level can shift the constant growth trend up or down. One example of such shocks is innovations. Zandweghe (2010) argues that the output rises if the technology level increases, creating more output per hour worked: Changes in technology, as broadly defined in common macroeconomic models of the business cycle, correspond to supply shocks. In the case of Azerbaijan, a technology revolution in the oil industry allowed companies to produce more output with the same amount of workers. Thus the rise of the labor productivity in the field of oil and gas embodied in general relative figures.

To this end, the role of modernization in driving fluctuations in labor productivity is beyond dispute. The Heckscher-Ohlin theory argues that international differences in labor along with the other factor endowments create productive differences. So Azerbaijan needs to raise its labor skills to catch up in competitive advantage. Azerbaijan's non-oil exports have relied heavily on labor intensive food processing, beverages and agriculture. Switching from exporting raw materials and labor intensive goods to capital intensive goods demands increased labor productivity. The driving forces behind labor productivity are modernization, increases in skills, and improvement of management. Azerbaijan's competitiveness should be reinforced by a strong focus on labor productivity which comes from a steady improvement in education and training, as educated workers do the work of greater numbers of less educated workers.

Conclusion

To ensure economic diversification through producing various goods and services and reducing dependent on resources is the main objective of resources-rich countries like Azerbaijan. Toward this end, innovation-led progress gradually replaces traditions and outdated technology which are obstacles to economic growth. Of course, a balance should be found between modernization and cultural values.

Table 7. The ways to improve of labor productivity in Azerbaijan

Modernization	Increases in skills	Institutional capacity
<ol style="list-style-type: none"> 1. Providing incentives to business for the technological improvement 2. Establishing a technological parks and clusters 	<ol style="list-style-type: none"> 1. Increasing of public and private spending on education 2. Meeting the orientation and structure of the labor market 3. Development of a strong national training system 4. Supporting new entrants to the labor force in terms of skills gap 5. Upgrading secondary and higher technical schools 6. Stimulating training activity in large and medium firms 	<ol style="list-style-type: none"> 1. Development program on scientific and technological progress 2. Coordination of think tanks, educational institutes and business 3. Improvement of private funding of scientific research and technological development 4. Increasing of state funding on R&D 5. Improving market access for the output of SMEs

Rational replacement of traditional thinking style, behavior and technology by a more modern form would lead to an effective diversification of economy in Azerbaijan. Having opened its economy to the world, Azerbaijan has embraced globalization. In order to fulfill the gap between developed and developing nations, modernization and diversification are “stock in trade” for convergence.

Government support to operationalize the system based on meritocratic approach, highly-developed human capital and infrastructure would lead Azerbaijan to an economic miracle.

References

- Arip M.A., Yee L.S. and Karim B.A. 2000. “Export Diversification and Economic Growth in Malaysia,” p. 8. <http://mprapaper-20588.pdf>
- _____. 2007. “Black Sea Economic Cooperation, Study on Trade and Investment Potential.” UNDP.

- Castiglione C. 2011. Verdoorn-Kaldor's Law: an empirical analysis with time series data in the United States *Advances in Management & Applied Economics*, vol. 1, no. 3, p. 160. International Scientific Press.
- Castiglione C. 2011. Verdoorn-Kaldor's Law: an empirical analysis with time series data in the United States *Advances in Management & Applied Economics*, vol. 1, no. 3, p. 170. International Scientific Press.
- Chung Y. 2007. *South Korea in the Fast Lane: Economic Development and Capital Formation*, p. 42. Oxford University Press.
- _____. 2011. Conference Board Total Economy Database Output, Labor and Labor Productivity Country Details, 1950-2010. (January)
- Engle R.F. and Granger C.W.J. 1987. "Cointegration and error correction: Verdoorn-Kaldor's law representation, estimation and testing." *Econometrica*, 55(2), pp. 251-276.
- Gelb A. 2010. "Economic Diversification in Resource Rich Countries, Center for Global Development," p. 1. <http://www.imf.org/external/np/seminars/eng/2010/afrfin/pdf/Gelb2.pdf>.
- Gonel F.D., Kaplan Z., Ozer F. "Trade liberalization, trade performance and competitiveness: Turkey is at a crossroad in its trade pattern." <http://www.etsg.org/ETSG2009/papers/gonel.pdf>.
- Gordon R.J. 2010. "Okun's Law and Productivity Innovations." *American Economic Review: Papers & Proceedings*, 100, p. 14.
- Granger C. W. J. 1969. "Investigating Causal Relations by Econometric Models and Cross-spectral Methods." *Econometrica* 37(3), pp. 424-438.
- Granger C.W.J. 1986. "Developments in the Study of Cointegrated Economic Variables." *Oxford Bulletin of Economics and Statistics*, 48(3), pp. 213-228.
- Granger C. W. J. and Newbold P. 1974. "Spurious regressions in econometrics." *Journal of Econometrics* 2, pp. 111-120.
- Hamalainen K. and Pehkonen J. 1995. "Verdoorn's Law in the Multivariate Context." *Economic Notes*, 24(1), pp. 175-186.

- _____. Investment climate in Azerbaijan, <http://www.azerbaijans.com/content-1614-en.html>.
- Kaldor, N. 1966. Causes of the Slow Growth in the United Kingdom. Cambridge: Cambridge University Press, p. 289.
- _____. Key Indicators of the Labour Market, ILO, <http://kilm.ilo.org/manuscript/kilm17.asp>.
- Knell, M. 2004. "Structure Change and the Kaldor-Verdoorn law in the 1990s." *Revue d'économie industrielle*, Vol. 105, 1er trimestre 2004, p. 71.
- _____. Knowledge Economy Index (KEI) 2012 Rankings, World Bank, 2012, <http://siteresources.worldbank.org/INTUNIKAM/Resources/2012.pdf>.
- Kydland F. E. and Prescott E.C. 1982. "Time to Build and Aggregate Fluctuations." *Econometrica*, Vol. 50, No. 6, pp. 1345-1370.
- _____. Labour Market, The State Statistical Committee of the Republic of Azerbaijan, <http://www.stat.gov.az/source/labour/indexen.php#007>.
- _____. Labor Productivity and Growth, Global Finance, <http://www.gfmag.com/tools/global-database/economic-data/11857-labor-productivity-and-growth.html#axzz2HyvVcF3o>.
- Narulla R. 2005. Knowledge creation and why it matters for development: The role of TNCs, Globalization of R&D and Developing Countries, UNCTAD, p. 58.
- _____. 2003. "Reaching the Rural Poor: Strategy and Business Plan." World Bank internal report.
- _____. 2005. "Realizing Azerbaijan's Comparative Advantages in Agriculture." Azerbaijan Agricultural Markets Study, The World Bank.
- _____. Resilience in Emerging Market and Developing Economies: Will It Last? IMF, <http://www.imf.org/external/pubs/ft/weo/2012/02/pdf/c4.pdf>.
- Romer, P.M. 1989. "Human Capital and Growth: Theory and Evidence," p. 2. University of Chicago.
- Rowthorn R. E. 1979. "A Note on Verdoorn's Law." *The Economic Journal*, Vol. 89, No. 353. p. 131. Wiley on behalf of the Royal Economic Society. Stable URL: <http://www.jstor.org/stable/2231413>.

- Samen S. A. 2010. "Primer on export diversification: Key concepts, theoretical underpinnings and empirical evidence," p. 3. Growth and Crisis Unit World Bank Institute,
- Stryker J.D., Ahmadov V., Rashidova T., and Paula D.C. 2009. Domestic Resource Cost Analysis of Azerbaijan. Presented by Chemonics International (USAID)
- _____. 2004. "Study of Azerbaijan's current and potential comparative advantage." Center of Economic Reforms Ministry of Economic Development and UNDP.
- Sjo B. 2008. "Testing for Unit Roots and Cointegration," p. 10, <http://www.iei.liu.se/nek/ekonometrisk-teori-7-5-hp-730a07/labbar/1.233753/dfdistrib/ab7b.pdf>.
- _____. "The Knowledge Economy and the Changing Needs of the Labor Market." World Bank, <http://siteresources.worldbank.org/INTLL/Resources/Lifelong-Learning-in-the-Global-Knowledge-Economy/chapter1.pdf>.
- Thirlwall A. P. 1983. "A Plain Man's Guide to Kaldor's Growth Laws." *Journal of Post Keynesian Economics*, Vol. 5, No. 3, pp. 345-358.
- Verdoorn, J. P. 1995. "On the Factors Determining the Growth of Labor Productivity." L. Pasinetti ed. *Italian Economic Papers*, Vol. II, Oxford: Oxford University Press.
- Zandweghe W.V. 2010. "Why Have the Dynamics of Labor Productivity Changed?" *Economic Review*, 3rd quarter, p. 12, <http://www.kansascityfed.org/publicat/econrev/pdf/10q3VanZandweghe.pdf>.

Building a Korean-Portuguese Business Partnership for Sub-Saharan Africa: Opportunities and Challenges in Mozambique

Luis Mah¹⁾

1. Introduction

Africa is now, as *The Economist* recently put it, the “hopeful continent”. With remarkable economic output since 2000 - annual average growth close to 5 percent, improved trade revenues, reduced macroeconomic imbalances, stronger consumer markets and enhanced business productivity, Africa is attracting the attention of many markets and investors. The Republic of Korea is a latecomer development aid and trade partner of the African continent. The Korea Africa Forum for

1) Luis Mah is currently a Research Fellow at the Center for African and Development Studies (CESA) at the School of Economics and Management (ISEG) /Technical University of Lisbon, Portugal.

Economic Cooperation (KOAFEC) is the main instrument through which Korea is building cooperation ties with Africa. It includes both overseas development aid (ODA) and economic cooperation programmes that are implemented via Action Plans approved during these forums. Africa is now Korea's second largest recipient of ODA. Yet, Africa remains a marginal trade partner for Korea. As the continent continues to show high economic growth and market potential in terms of access to natural resources and new consumers, Korea needs to start thinking about strengthening its engagement with Africa. Unlike Korea, Portugal has been a strong trade partner of Africa, particularly through its investments in two of the fastest growing economies in the continent, Angola and Mozambique. Historical, political, economic, educational, and cultural ties as well as language have played a crucial role in nurturing trade relations. The current economic and financial crisis in the European Union is pushing Portuguese companies to strengthen their presence in booming Portuguese-speaking African countries. Due to Korea's weak links with the continent, this paper will attempt to critically analyse the opportunities and challenges for Korean businesses in building partnerships with Portuguese companies to enhance their entry into fast-growing African markets. The paper will focus on Mozambique as a case study.

2. From “Hopeless” to “Hopeful” Continent: The Rise Of Sub-Saharan Africa

During the second half of the 20th century, Sub-Saharan Africa's path to liberation and independence from colonial domination brought a new sense of confidence and political will to foster economic and social progress to the

continent's nations. But the collective aspirations of Sub-Sahara African populations for better lives would soon be challenged by the violence and disorder brought by domestic conflicts, border disputes and Cold War-related power games in the region. As most of the region descended into crisis, it became increasingly difficult to address weak governance, state-building dilemmas as well as fragilities in political, economic and social policy that were not unusual to newly independent nations. By submitting to conditions of becoming beneficiaries of external aid many of the region's nations, while politically independent, lost much of their economic autonomy and capacity to define their own development.

However, since 2000, and despite the slow rate of reduction in poverty and inequality reductions, Sub-Sahara African countries have achieved remarkable results economically: annual average growth close to 5 per cent, improved trade revenues, reduced macroeconomic imbalances, stronger consumer markets and enhanced business productivity. This contrasts with a disappointing performance between 1960 and 2000: low growth rates, decreasing real incomes and productivity, diminishing capital inflows and a decreased share of the world exports. The transformation from a "hopeless" continent to a "hopeful" Africa is the latest mantra of multilateral organisations such as the World Bank or the International Monetary Fund, global banks, leading think tanks, consultancy firms and media.

1.1 Sub-Sahara African Economic and Development Trends: The Debate

Sub-Saharan Africa has managed to escape the slowdown of the global economy and economic growth in the region continued to be strong at 4.6% in 2012. The estimates for the region are even better for the coming years with economic growth expected to average 5 per cent over the period of 2013-2015

(World Bank 2013). Growth in 2012 was helped mainly by robust domestic demand, increasing remittance and foreign capital flows, high commodity prices and enhanced export volumes (World Bank 2013).

Consumer spending has grown rapidly in recent years, supported by real per capita income growth of an average 2.3 per cent for the past decade. Consequently, as of 2012, 21 Sub-Saharan African countries began to be classified as middle-income economies, compared to only nine a decade ago (World Bank 2013). In the World Bank's definition, a country classifies as a middle-income economy (or MIC) when it crosses the USD 1000 GDP per capita threshold (Fengler & Devarajan 2012). The MIC status does not mean that the country stopped having high levels of poverty and low human development indicators but it opens up membership in a club of countries such as Malaysia, Thailand, Indonesia, Brazil or China that have access to financial resources from global capital markets. This economic tendency has already offered new perspectives on African markets with the emergence of a debate on an African middle class or the rise of the African consumer. In April 2011, the African Development Bank (AfDB) published a market brief entitled "The Middle of the Pyramid: Dynamics of the Middle Class in Africa" (AfDB 2011). The brief presented the results of a study undertaken by the multilateral institution revealing that by 2010, the African middle class had risen to 34.3% of the population – nearly 326 million people – up from about 115 million or 26.2 per cent in 1980, 157 million or 27 per cent in 1990 and 204 million or 27.2 per cent in 2000 (AfDB 2011). But the study also made it clear that among the three sub-types it defined as "middle class", the one at the bottom could easily fall into poverty again. These latter ranks are also called the *floating class*, i.e., a middle-class sub-category with per capita consumption levels of between USD 2–4 per day and that remain vulnerable to slipping back to poverty in case of some exogenous shocks; it represents about 216 million people. Using

a stricter definition of middle class by considering a minimum threshold of USD 4 per day would put the continent's middle class at about 138 million people. The study also showed that the majority of the African middle class is likely to obtain its income from salaried jobs or small business rather than from agricultural and rural economic activities. Finally, the authors noted that the growth of the middle class in the continent contributed to the growing domestic consumption in many African countries. This is widely expected to nurture local private sector growth as "a key source of effective demands for goods and services supplied by private sector entities" (AfDB 2011). They, however, also stressed that income inequality continued to be very high with about only 100,000 Africans holding a net worth of USD 800 billion in 2008 (about 80% of the total for Sub-Saharan Africa).

The private sector seems to have noticed these changing social patterns in Africa, with McKinsey Company launching a report in October 2012 titled "The rise of the African consumer" (McKinsey & Company 2012). For David Fine, the director of McKinsey & Company and who leads McKinsey's office in South Africa, "the continent's consumer industries are expected to grow a further USD 410 billion by 2020 –more than half the total revenue increase that all businesses are expected to generate in Africa by the end of the decade" (Fine 2012). The World Bank points out in its Global Economic Prospects of January 2013 that although consumer data for most of Sub-Saharan Africa is scarce, available indicators point out strong consumer demand in the region supported by better access to credit, decreasing inflation rates and lower interest rates, higher rural income due to weather conditions and robust remittance flows (World Bank 2013).

The strength of domestic demand is expected to be supported further by the growth of remittances (to reach about USD 27 billion by 2014) and investments in infra-structures (through new external sources of finance) that will increase

productive capacity (Chuhan-Pole, Angwafro, Buitano, Dennis, Korman & Sanoh 2012). Export growth was relatively strong in 2012 and it was supported by earlier export investments and diversification of trade partners beyond Europe and the US to include Asian countries, in particular (World Bank 2013). Additionally, the value of the exports increased due to high commodity prices.

But this narrative of success is not without a competing view that states that Africa's growth is a mere product of high commodity prices with African exports highly concentrated in primary commodities. The share of the manufacturing sector has not increased and as Rick Rowden stresses "the bulk of African countries are either stagnating or moving backwards when it comes to industrialization" (Rowden 2013). Despite improvements since 2000, the continent, as whole, continues to deliver the lowest human development indicators in the world. The last Africa Human Development Report 2012 shows how the continent, with ample agricultural land, plenty of water and good climate to grow food, is failing to feed its population with one in four Africans undernourished and food insecurity remaining an issue: "the spectre of famine, which has virtually disappeared elsewhere in the world, continues to haunt parts of Sub-Saharan Africa. Famines grab headlines, but chronic food insecurity and malnutrition are more insidious, often silent, daily calamities for millions of Africans" (UNDP 2012). Corruption remains rampant in many African countries as highlighted every year by the Corruption Perceptions Index released by Transparency International (Transparency International 2012).

Shantayanan Devarajan and Wolfgang Fengler, leading economists from the World Bank, have tried to explain these diverging views of an Africa that is simultaneously growing fast and reducing poverty gradually but failing to create jobs, invest in infrastructure and human capital. They point out that: "the growth and poverty reduction of the last decade were the result of improvements in the

macroeconomic policy environment and political stability. The remaining challenges of infrastructure, employment and human development also have their roots in weak policies and institutions – what we call “government failures” (Devarajan & Fengler 2012). Devarajan and Fengler argue that despite these government failures, there are signs that allow us to maintain an optimistic view of the future of Africa, resulting from deep changes in African societies. The authors claim that democratization, demographic changes, rapid urbanisation, higher levels of education and the widespread use of cell phones opening more areas to free information sharing have had an impact on the African policymaking process (Devarajan & Fengler 2012). Finally, Morten Jerven from Simon Fraser University writing in *This is Africa*, a sister publication of The Financial Times, argues that African GDP statistics “tell us less than we would like to think about income, poverty and growth” (Jerven 2012). He provides the example of Ghana that became overnight a middle-income country in 2010 after the country’s Statistical Services revised its GDP estimates upwards by over 60% suggesting that about USD 13 billion of economic activities had been previously missed. The reason rested in the fact that 1993 was the previous baseline data used to measure Ghana’s economic growth. Since this year, the structure of the economy has transformed rapidly with the introduction of new technologies, the continued liberalisation of the economy and emergence of a thriving private sector.

As Richard Dowden, the well-known Director of the Royal African Society states: “Africa- as I have always thought – is a lot richer than is generally assumed. However, at the bottom of the pyramid, people can become vulnerable quite quickly especially when there is war. So expect to see those horrifying pictures of starving children from time to time as well as lots of cool young Africans in fashionable clothes driving flashy cars. Both are real. Both are Africa (Dowden 2013).”

3. Go Africa? Korea's Engagement with the Emerging Continent

As with other so-called late-comers to Africa, Korea has also sought to build ties with the continent in the past years. The Korea Africa Forum for Economic Cooperation (KOAPEC) is the main instrument through which Korea is building cooperation ties with Africa. It includes both development aid and economic cooperation programmes that are implemented via Action Plans approved during these forums (KOAPEC 2013). The first KOAPEC was held in 2006, followed by two others in 2008 and 2010. They were all hosted in Korea. The Korean International Co-operation Agency (KOICA) is the country's agency in charge of implementing its bilateral aid grants and technical cooperation policies, with focus on: education, health, agriculture, forestry and fisheries, ICT, industry and energy, the environment, disaster relief, climate change and MDGs. As the most recent member (24th) of the OECD/DAC, Korea is now a donor country. Regarded as the main institutional arrangement by traditional donor countries, the DAC conducts research on best practices and themes of interest for aid effectiveness and reviews its member's development cooperation programs approximately every four years. Africa, in particular Sub-Saharan Africa, is the second largest and one of the fastest growing recipients of Korean ODA. Its share has sharply increased since 2005, from around 1% in 2004 to 19.1% in 2009, with a total of USD 53.31 million (KOICA 2013).

Additionally, at the last KOAPEC, the Korean government announced that Seoul intended to increase the Economic Development and Cooperation Fund (EDCF) administered by the Korea Export-Import Bank (Korea Eximbank) almost twofold to USD 1.1 billion by 2015, compared to USD 590 million for the period 2005-2009 (Kang 2011). A recent report from the Standard Bank of South Africa has showed that Korea has succeeded in tapping into the growing African consumer

markets (Freemantle & Stevens 2012). Since 2008, Korea (+48%), India (+45%) and China (+38%), along with Malaysia, have been the leaders in consumer imports into Africa. In contrast, the major European economies have struggled to compete with the new Asian competitors in the African market: Italy (-14.2%), Spain (-3.3%), Germany (-2.3%) and the U.K. (-2.2%) have all lost consumer market share since 2008. Among the exceptions among European economies that have managed to increase their share of African consumer markets are the Netherlands (7%) and Portugal (8%).

Sub-Saharan Africa remains a marginal trade partner for Korea. Though having an economy that has already succeed in surpassing the USD 1 trillion trade mark in 2011, Korea's volume of trade with Africa was only slightly over USD 15 billion in 2012 (KITA 2013; Kim 2011). While Korea imports essentially primary commodities from Africa, its exports to Africa are dominated by machinery and transport equipment, manufactured goods and chemical products. In 2012, Korea's exports to Africa were concentrated in three main countries: Liberia, South Africa and Nigeria (KITA 2013). Liberia's large share of trade with Korea results from vessels registered in that country but not owned by Liberians (Kang 2011). Imports from Africa in 2012 were led by South Africa, Nigeria and Equatorial Guinea (KITA 2013).

In face of the current economic scenario for the African continent, Korea cannot shy away from building stronger ties with the continent as it would mean not only access to an important supply of natural resources but also new business deals in a booming infrastructure drive and a new consumer market totalling hundreds of millions. While lacking the capacity to fully engage all 53 African countries, Korea could focus on a particular set of countries. Despite weak trade relations, one of those countries could be Mozambique (KITA 2013). The best argument lay in the fact that this is the country in which Korea achieved one

of its greatest successes overseas in terms of access to natural resources: the discovery of offshore natural gas. The opportunities are many but the challenges are also many.

4. The Political Economy of Mozambican Growth and Development

Mozambique is usually regarded by donor countries as one of the few successes in Africa with a story of peace, political stability and economic growth since the conclusion of the General Peace Agreement and the ending of its civil war in 1992. It is also the only country among the fastest growing African economies, where there has been political leadership transitions over the past 20 years without negatively affecting the country's economic growth, unlike most of Sub-Sahara African countries.; This political leadership transition occurred, however, under the continuing dominance of the liberation party Frente de Libertação de Moçambique (FRELIMO) since the independence from Portugal in 1975.. Consequently, donors, in particular European countries, have provided significant financial aid resources to support the country's economic, social and political performance (de Renzio & Hanlon 2007).

The country remains highly dependent on foreign aid but is considered as a model by the World Bank and the International Monetary Fund (IMF), having consistently met most donor demands. In the past, the international donor community has helped Mozambique to adopt one of the most detailed budget support initiatives, with annual aid flows averaging almost a quarter of its annual gross national income and direct budget support accounting for more than half (51.4%) of the national budget until 2010. Budget support is a leading development

aid innovation to finance the recipient country's economic and social reforms through the transfer of financial resources from donor countries to the recipient's national budget. The financial resources that are transferred are managed in accordance with the recipient country's budgetary procedures. This is different from what has been the dominant development aid practice of financing specific programmes or projects. However, since 2010, the national budget has begun to be financed by growing domestic revenues derived mainly from the exploration of natural resources and the donor's share of the budget has fallen significantly to 39.6% in 2012 and is projected to drop further to 33% in 2013 (Malin 2012).

According to the African Economic Outlook 2012, the country's GDP real growth rate reached 7.2% in 2011 as a result of the first overseas export of coal from the first mega coal mining projects in the province of Tete together with a strong performance in the financial services sector, transport, communications and construction (African Development Bank, OECD, UNDP & UNECA 2012). Private sector investment surpassed USD 1.9 billion in 2011 and a total of 30,000 jobs were created by 285 new projects. In 2012 and 2013, economic growth is expected to hit 7.5% and 7.9%, respectively, as new foreign direct investment (FDI), mostly in extractive industries, continue to enter the country. Strong investments have also been welcomed in the agricultural sector and for infrastructure-building. The boom in infrastructure-building is centred around the country's 3 main logistic corridors (Maputo, Beira and Nacala) with the cement industry expected to triple production by 2013. Five new companies (the Chinese Africa Great Wall Cement Manufacturer, China International Fund, GS cimento, and Bill Wood and the South African Pretoria Portland Cement) are to enter the market with an expected overall investment of USD 450 million (African Development Bank, OECD, UNDP & UNECA 2012).

The most relevant economic development and news of 2011, however, was the discovery in September of extensive off-shore natural gas reserves in the Rovuma Bay in the province of Cabo Delgado, northern Mozambique. The estimates for cumulative natural gas reserves, if proven correct, will position Mozambique in the 4th place in the world in terms of natural gas reserves behind Russia, Iran and Qatar. Due to expectations concerning the reserves, a liquefied natural gas (LNG) plant is to be built in Mozambique. During the last decade, Mozambique achieved an average 7.2% GDP growth to make it one of the fast growing economies in the African continent (African Development Bank, OECD, UNDP & UNECA 2012).

The most recent IMF Fifth Review Under the Policy Support of Mozambique released in early January 2013 states that: “Economic growth remained buoyant and macroeconomic stability was maintained, building on a track record of strong macroeconomic policies that effectively supported growth while bringing down inflation and strengthening international reserves” (IMF 2013). The growing international confidence in the economic conditions of Mozambique, in particular for 2013, has been further highlighted by Fitch Ratings that has placed the country in a positive outlook leading to a possible sovereign rating upgrade. Yet, to win the upgrade Mozambique would have to improve physical and social infrastructure while keeping a prudent fiscal policy (Whitehead 2012).

1.2 The Paradox of Mozambican Rapid Economic Growth: Low Human Development Indicators

At the same time, while growing rapidly during the last decade, Mozambique’s growth rates have been largely driven by a few enclaves and strong capital-intensive mega projects in the extractive industries that have not had a relevant impact in

terms of job creation, better distribution of economic wealth or poverty reduction. The statistical growth of manufacturing as a share of GDP is essentially due to MOZAL's output, the country's largest aluminium producer. Getting a formal job in Mozambique continues to be difficult and the estimated annual entrance of 300,000 new job-seekers in the labour market poses difficult challenges for the government. Overall unemployment rate stands at 27% and formal jobs are mostly in the cities and accounts only for 32% of all employment. In consequence, new job-seekers tend to enter the urban and rural informal economy, with little opportunity to find stable employment (de Paepe 2012).

While unemployment remains high in the country, there have been significant improvements in terms of human and social development. The Human Development Report 2011 "Sustainability and Equity: A Better Future for All" shows that from 1990 to 2011, the value of Mozambique's Human Development Indicators (HDI) increased from 0.200 to 0.322, an average annual increase of 2.28%. These figures are higher than the average for Sub-Saharan Africa in the same period (0.90%) as well as low human development countries (1.31%). From 2000 to 2011, the average annual increase in HDI value grew further to 2.49%. During this period, Mozambique was one of the top 5 performers in the world. Yet, Mozambique continues to be ranked at the bottom of the UNDP index. In 2011, Mozambique ranked 184 of a total of 187 countries in terms of HDI (Kring 2011).

As aid flows, which have been crucial to sustaining human and social improvements, are expected to decrease in the coming years, the diversification and the strengthening of the revenue base, in particular through higher and better taxation of the extractive sector, becomes crucial to promoting and sustaining a growth agenda based on the creation of jobs and tackling persistent poverty issues. Mozambique like several other African countries in similar conditions, is facing the need to transform its current economic model based on the "extractive

economy” focused on exports of raw commodities; into an economy that raises agricultural productivity along with the development of new, labour-intensive and more productive sectors such as manufacturing and agro-business.

Despite the fact that 60-70% of the Mozambican population live in rural areas and depend on agriculture for employment or livelihood, Mozambique’s agricultural development has failed to become a driver of poverty reduction despite the government’s stated intentions for the past decade. As Cabral, Shankland, Locke and Duran point out: “Food insecurity and malnutrition continue to affect the Mozambican population and rural poverty has, at best, been marginally reduced, although increasing in central regions. Mozambique’s crop output has remained stagnant over the last decade. Sorghum and cassava, the main crops produced by the predominant smallholder sector, continue to have poorly developed value chains. Productivity remains low across the board and most growth recorded by the sector is explained by farmed land expansions rather than efficiency gains” (Cabral, Shankland, Locke and Duran 2012).

This is even more striking, when in 2010, less than 14% of the 36 million hectares of arable land had been farmed, mostly by smallholders, and of these only 2% had been irrigated. For Cabral, Shankland, Locke and Duran there is a three-tier causational explanation for the current condition of the sector. First, the sector has suffered from inadequate technology and extension services, poor infrastructure and absence of markets for inputs, services and outputs (for example, even during times of good food production, surpluses from rural areas failed to reach potential urban consumers). Second, these causes are the result of a series of factors such as the legacy of a civil war, ill-fitted public policies, feeble governance, development aid squandering and lack of private capital. Finally, politics can be said to be the ultimate explanation for the sector’s poor performance as policies have tended to discriminate against the majority of smallholders (Cabral,

Shankland, Locke and Duran).

This seems to be particularly evident in the most recent mega agribusiness project in the country, ProSavana. Led by Brazil, ProSavana has raised expectations that it could answer some of the recurring issues affecting Mozambique's agricultural sector. The project aims at transforming 14 million hectares of the savannah along the country's northern Nacala Corridor into highly productive agricultural land that will be explored by large firms and smallholders. Based on the Brazilian experience, the promoters of the project claim that smallholders will be supported through locally-fitted technology (improved seeds suitable for Mozambican soils) and environmentally-friendly farming techniques. Additionally, the smallholders will be able to join an export-oriented agriculture value chains through contract farming and the promotion of cooperatives (Cabral, Shankland, Locke and Duran 2012).

But local leaders from the National Peasant's Union (UNAC) after meeting in Nampula in October 2012 to discuss ProSavana released a declaration stating that they were concerned with the lack of information and transparency from the participating governments in the project (Mozambique, Brazil and Japan) as well as the lack of involvement of civil society in the process. They also condemned any attempt of land resettlement and expropriation to give place to mega agribusiness and arrival of Brazilian agribusiness transforming Mozambican farmers into their employees and rural workers (UNAC 2012).

In addition, another issue that is expected to pose a growing threat to agricultural development and productivity in Mozambique is climate change. A 2010 World Bank Report entitled "Economics of Adaptation to Climate Change: Mozambique" argues that over the coming 40 years, the impact of climate change will lead to a decrease of 2-4% in yields of major crops, especially in the central region. Combined with frequent flooding of rural roads, this could result in an

agricultural GDP loss of 4.5% (optimist scenario) or 9.8% (pessimist scenario) (The World Bank 2010).

1.3 From Policy Dependence to Growing Policy Space

The discovery of vast reserves of mineral resources in Mozambique is expected to reduce the leverage donor countries have had on the country's governance. This will open an opportunity for the government to gain more policy space, i.e., more autonomy in designing and implementing public policies. This has led to a growing debate in the country on the role of the state and how to avoid the “resource curse”, a common feature in poor but resources-rich developing countries (Hofmann & Souza Martins 2012). Mozambican authorities are now facing the need to enhance their natural resources management to guarantee environmentally and intergenerational sustainability. The authorities seem to be aware of the paramount need to update and strengthen the legal, regulatory and institutional frameworks as the country begins to benefit from the natural resources windfall and have to enter into new forms of engagement with the private sector, particularly large multinationals.

The challenges are many as pointed out by the Norwegian Anti-Corruption Resource Center U4: “In Mozambique prevalence of corruption remains an area of concern for both the public as well as donors, who support almost half of the state's budget. Corruption manifests itself through various forms, including political, petty and grand corruption, embezzlement of public funds, and a deeply embedded patronage system. Checks and balances are weak, as the executive exercises strong influence over the legislative and the judiciary. Corruption also affects several sectors in the country, such as the police, public administration, judiciary, and public financial management” (Anti-Corruption Resources Center

U4, 2012). The latest Transparency International Corruption Perceptions Index of 2012 ranked Mozambique 123rd out of 174th countries (Transparency International 2012).

The declaration in October 2012 that Mozambique had become fully compliant with the Extractive Industries Transparency Initiative (EITI) reveals that the country's authorities are making significant steps to address criticisms for failing to offer more transparency and accountability on issues related to revenues from the exploration of its natural resources (EITI 2012). But as important as the legal, regulatory and institutional framework is the way in which the authorities will engage communities in the areas where the exploration of the natural resources will take place in the coming years. The recent conflicts between the Brazilian mining company, Vale do Rio Doce, and the resettled villagers from Cateme, in the region of Tete shows that there is still much work to be done on this issue (Polgreen, 2012 and Mosca & Selemene 2011).

The Mozambique government needs to build the capacity to wisely use the revenues from the extractive industries as a platform to diversify the country's productive base, fortify their human capital and ultimately create an internal market. This necessarily requires a better holding of the rents derived from natural resources by the authorities in order to effect these structural changes over time and reduce the country's ongoing dependency on external financing. A joint report released on December 2012 by non-governmental organizations Friends of the Earth Mozambique, Jubilee Debt Campaign and Tax Justice Network, with new information in the public domain and released under the UK Freedom of Information Act, shows clearly how the single biggest private sector project ever made in Mozambique, the Mozal aluminium smelter, pays only 1 percent tax on gross revenue from aluminium sales to the Mozambican government. With an average revenue of USD 1.2 billion, 1% tax would raise USD 12 million in taxes per year. Mozal

pays no tax on profit, or any sales, customs or circulation taxes. The report estimates that for every USD 1 paid to the Mozambican government, USD 21 left the country in profit or interest to foreign governments and investors (Friends of the Earth Mozambique, Jubilee Debt Campaign & Tax Justice Network 2012).

Only now does the Mozambican government seem to be acting on this issue. The current Minister of Finance, Manuel Chang, has confirmed in late December 2012 that a governmental technical team will renegotiate the megaproject contracts, in particular the tax benefits and other concessions. The megaprojects most likely to be affected are Mozal, exploration of natural gas (Sasol), heavy sands (Kenmare) and coal (Rio Tinto and Vale do Rio Doce) (Rádio Moçambique 2012). Mozambique is in a critical juncture and ultimately whether or not the country will positively transform its economic structure will depend on the role of the state in managing sustainably the windfalls from the exploration of the country's natural resources.

As Isabelle Ramdoo states: “the new architecture that is setting in place calls for new forms of coalition between the Government, the extractive industries and the donor community. As much as it is an opportunity for donors to re-think and redefine their engagement with Mozambique, it calls for the Government to adopt an inclusive approach in order to generate synergies and complementarities with these actors that have so far played a crucial role or are expected to do so in the future. On the operational side, there has been little coherence and alignment with what the industries attempt to do on their side to contribute to development, with what the donors and government agree to achieve together at the national or sub-national level, in particular to promote transparency and domestic resource mobilization. Mozambique will need to bring all its partners to the table to engage constructively on concrete development outcomes if it wants to tap into the value added of each partner” (Ramdoo 2012).

As important as good policies to nurture the country's economic growth and development is the capacity of the political system to adapt to the rapid changes in the economy as a result of the newfound wealth from its natural resources. The ruling party FRELIMO is set to remain the dominant political power for the foreseeable future, with good organisation and widespread support in the country (Hanlon, 2012). But patronage seems to remain relevant in the workings of FRELIMO and government with complaints that membership in the party was becoming a requirement for promotion in the civil service, for access to loans, scholarships, housing, licences, etc from governmental sources and institutions (Hanlon, 2012). Since 2003 the previous tendency following the first multiparty elections in 1994 to separate party and State seems to have been reversed with the current Presidency of Armando Guebuza. As Marc de Tollenaere stresses: "the split between party and state was seen as the cause of a near electoral loss in 1999 and had to be reversed. Guebuza revitalized the party structures from top to bottom and made it no secret that the State was the principal instrument to reproduce the power of the party"(de Tollenaere, 2012). De Tollenaere highlights that membership in the party increased from 1.6 million in 2003 to 3.6 million in 2012. Despite some successes of the opposition (like the victory in the municipal elections in the country's second and fourth major cities, Beira and Quelimane, respectively) and the high electoral abstention, FRELIMO holds a qualified majority in the parliament, controls most of provincial assemblies, governs 41 out of 43 municipalities and won the presidency with 3/4 of the votes.

1.4 The Return of the State?

Since the 1990s, the State has been pushed aside as the country undertook a vast programme of privatisations that benefit military and political leaders

(Pitcher, 1996). This was what Hanlon called the time of “savage capitalism”(Hanlon, 2009). A group of new domestic elite business groups, most with strong ties to FRELIMO, has since then emerged to play an increasing role in the country’s economy, in particular in building the infrastructures and logistics supporting the extractive sector (ports, railways, roads and bridges). A good example is Insitec that recently became the country’s largest business group with interests in the second largest bank (BCI), the northern railway and port system and the company that holds the concession for the Mpanda Nkuwa dam. In June 2011, it bought CETA, Mozambique’s largest building and engineering company (Hanlon, 2012). The importance of these political-business ties in Mozambique and the potential conflict of interests has led the country’s main anti-corruption non-governmental organisation, the Centro de Integridade Pública (Center for Public Integrity), to start a database on who’s who in the business sector in Mozambique (CIP, 2012). De Tollenaere, again, offers an interpretation behind its economic rationale: “this produced an economic model that was increasingly driven by the need to control access to the national economy and the drive to seek rent. One of the characteristics is the preference for large investments and for business that guarantees a quick return. FRELIMO old-hands will argue that there was no other option. If not, by mere lack of cash when liberalization started, the economy would have been entirely in foreign hands. Rent seeking was required to feed the ever-widening network of patronage. If not based on ideological conviction, loyalty and allegiance need to be bought. The point is not that FRELIMO intentionally tries to keep a majority of the Mozambicans poor. The point is rather that there are stronger political incentives than poverty reduction that have shaped the political economy of Mozambique and an emergent property of that political economy is that it does not produce inclusive growth”(de Tollenaere, 2012).

This may explain why in the latest report on Mozambique (December 2012), the Economist Intelligence Unit argues that despite reforms to improve business conditions in the country, progress have been slow “owing largely to political resistance to the removal of controls that benefit the state elite”(EIU, 2012). Mozambique continues, in fact, to achieve low rankings in international comparisons as shown by the Ease of Doing Business and Global Competitiveness Indexes. In the 2013 Ease of Doing Business Index, Mozambique came in 146th place out of 185 countries, dropping seven places from a year before, and below the average for Sub-Saharan Africa (140th place) (The World Bank, 2012). In the Global Competitiveness Index for 2011-2012, Mozambique got the 133rd position out of 142 countries. In the previous index, Mozambique was in 131st within a group of 139 countries evaluated by the World Economic Forum (WEF, 2012). Recent news provide some evidence that under President Guebuza, the Mozambican State is trying to reassert, after the period of privatisations in the 1990s, its role in economy.

First, in December 2012, the Mozambique state reacquired through purchase control over the Banco Nacional de Investimento or BNI (National Investment Bank) by acquiring the 50.5% owned by Portuguese shareholders (Hanlon, Newsletter 2012). The bank was originally set in 2010 by the Mozambican and Portuguese governments as a development and investment bank. It aimed in particular to finance large projects such as Cesul, the new central-south power line and Cahora Bassa north bank power station. Portuguese state bank Caixa Geral de Depósitos (CGD) owned 49.5%, Maputo-based Banco Comercial e de Investimentos (BCI), and itself under CGD, owned 1% and the remaining 49.5% was held by the Mozambican state's holding company Instituto de Gestão das Participações do Estado (IGEPE)(Lusa, 2012). The President has already stated that it intends to transform BNI into a national development and agriculture bank,

eight years after being rejected by donors (O País, 2012). The country's Minister of Finance, Manuel Chang said that the state-owned BNI would in the future finance riskier sectors such as agriculture, infrastructure and development, sectors with more difficulties in terms of access to private capital (Hanlon, Newsletter 2012).

Second, the takeover of BNI reveals a government-led acquisitions drive as it followed two other major purchases, the Cahora Bassa dam and Águas de Moçambique (Mozambique Waters). The Mozambican state already owned 85% of Cahora Bassa but decided to increase its share to 92.5% in 2012 after buying 7.5% to the Portuguese government. Águas de Moçambique was also held by the Portuguese Águas de Portugal (Portugal Waters) that controlled 73% of the company. In 2011, the Mozambican government acquired the control from Águas de Portugal for EUR 6 million. For the national newspaper O País, this shows a country where the State continues to be the main economic agent and player (O País, 2012).

Third, President Guebuza in his state of the nation address on 12th December 2012, announced that the government had already created the Empresa Nacional de Hidrocarbonetos-Logística (National Hydrocarbon Logistics Company) to provide services in the natural gas sector. In an interview for the special issue from *Great Insights* on Mozambique, President Guebuza made clear that the Empresa Nacional de Hidrocarbonetos-Logística was expected to encourage the private sector in Mozambique to develop around the gas sector and that his government would also attract foreign investment to invest in the industry in conjunction with domestic firms (ECDPM, 2012). A similar company is also soon to be set up for the mining sector, the Empresa Moçambicana de Exploração Mineira- Logística e Serviços (Mozambican Mining Exploration and Logistics Company) (Hanlon, Newsletter 2012). A new mining law, already approved by the government on 18th December 2012 will require mining firms to go through

Mozambique-based procurement of goods and services as a way to boost the number of contracts gained by Mozambican companies (Hanlon, Newsletter 2012). The main goal is to ensure that these state-owned companies will deal with developing upstream and downstream links to the megaprojects.

Finally, the signs leading to the enhancement of the role of the state in the economy are also patent in its desire to foster stronger social and human development. In its letter of intent to the IMF in early December 2012, the Mozambican government vowed to accelerate poverty reduction through more inclusive growth with the implementation of the country's Action Plan for Reducing Poverty –PARP (2011-2014). It will be focused on three main pillars: 1) enhancement of production and productivity in agriculture (aiming at an annual growth of agricultural output by 7 percent to double production by 2020 through higher productivity and expansion of cultivated land); 2) creation of jobs (around 200,000 jobs in the public and private sector each year but with a strong emphasis on commercial and industrial sectors) and 3) enhancement of social and human development (with improvement of access to, and the quality of, social services and infrastructure (IMF, 2012).

5. Portugal as a Business Partner for Korea in Mozambique

Unlike Korea, Portugal has been a prominent trade partner in Africa, particularly through its investments in two of the fastest growing African economies for the past 10 years, Angola and Mozambique. The country's ongoing financial woes that coincided with the economic crisis in its main market, the European Union, is pushing Portuguese companies to enhance their markets, business opportunities in these two countries. Despite the colonial past, political, economic,

educational, cultural and linguistic ties continue to play a crucial role in nurturing bilateral relations. As Angola is already regarded as a mature market for Portuguese companies that have maintained presence there for an extensive period, Mozambique has become a target (EUI, 2012).

In the case of Mozambique, Lisbon and Maputo have established regular bilateral summits in 2011 as a way to strengthen the political and institutional ties between the two countries. From an economic and trade perspective, bilateral trade has intensified with Portugal playing an increasing role as a trade partner of Mozambique. In 2011, Portugal was the sixth main supplier for Mozambique accounting for 4.40% of the foreign import totals (though its position did not change, its market share increased from 3.85% in 2010) and it was the 11th largest Mozambican client representing 1.44% of the latter's national exports (from the 17th position and 1.08% a year before) (AICEP, 2013). The data for 2012 does not include the position as a trade partner but Portugal exported goods totalling EUR 262.5 million, an increase of 36% relative to 2011 while total imported goods were valued at EUR 15.447 million, less 59% than a year before. This can probably be explained by the strong economic contraction of Portugal following the austerity measures (AICEP, 2013). In 2011, more than 2000 Portuguese firms exported to the Mozambican market, compared to 1520 in 2010, and they sold mainly machinery and equipment, metals, vehicles and other transportation materials, food products, wood pulp and paper and chemicals.

Portuguese companies are actively involved in the construction sector as Mozambique undertakes major infrastructure projects throughout the country. The energy and the offshore natural gas exploration are also expected to lead to major Portuguese investments. Portugal's oil and gas company, GALP Energia, will boost its investments following the discoveries (with ENI, Korea Gas Corp and Mozambique's state-owned ENH) of natural gas fields in the northern region of

the country. Portuguese power grid company Redes Energéticas Nacionais (REN) and China State Grid plan to go ahead with their first joint venture for the African market precisely in Mozambique. State Grid will join the consortium in charge of building the power transmission between Tete and Maputo. This project is part of the strategic partnership set during REN's privatisation in which State Grid acquired a 25% stake of the Portuguese firm (Gonçalves, 2012). The paper and pulp sector has also attracted the interests of a leading Portuguese company. Portugal's Portucel has won the land rights for approximately 360,000 ha in Mozambique and will build an export-oriented paper and pulp factory (Silva, 2010).

Finally, the country's economic growth has started to attract flows of Portuguese emigrants as they escape lack of jobs in Portugal. According to the Portuguese consulate in Maputo, there are 20,000 Portuguese citizens in the country (England, 2011). Since registration is not compulsory, the numbers do not offer an accurate picture of the total number of Portuguese in Mozambique. However, the Portuguese consul-general, quoted by the Financial Times, said that the registrations had increased by about 10 percent in the past two years providing an idea of the trend. This situation has already led the Mozambican authorities to announce that they will become stricter with concession of visas granted at arrival in the country (Lusa, 2013).

1.5. The Potential of Innovative Triangular Business Partnership in Mozambique: Korean, Portuguese and Mozambican firms and the Implementation of the Action Plan for Reducing Poverty (2011-2014)

In the field of development cooperation, triangular cooperation is a new modality that has been gaining international attention: "Triangular cooperation consists mainly of technical cooperation aimed at capacity building and takes place

mostly in the same region where both the emerging donors and beneficiary countries are located. It is often based on previous cooperation between traditional and emerging donors, that is considered successful and worth transferring to third countries”(Ashoo, 2010). In its current practice, triangular cooperation has not involved the private sector. Yet, its important role in driving economic growth and development remains “tangential to mainstream development policy and practice”(Davis).

For Peter Davis, the private sector can be a strong contributor for development: “Companies often have good access to finance and can invest in a scale that others cannot: they may have expert skills and knowledge, even the ability to develop their own technology, taking advantage of their scale. Because they are interested in market growth, they may help to encourage pro-growth policy outcomes and associated governance improvements. They are usually visible to the public and their leaders and they may feel, especially when foreign to the country in which they operate, the need to behave within moral norms that may be more demanding than legislation requires in their treatment of staff, in limiting any environmental harm and in being seen to contribute to the common good” (Davis, 2012). The potential to harness the contribution of the private sector for a country’s development can be, as Davis points out, optimised when there is a “genuinely symbiotic relationship between the actions taken by the state and corporate actors”(Davis, 2012).

Mozambique’s Action Plan for Reducing Poverty for 2011-2014 offer wider opportunities for an innovative triangular business partnership between Korean, Portuguese and Mozambican private firms to help the development of two of the country’s most important economic sectors needed to tackle poverty and unemployment: agriculture and manufacturing. A local partner is fundamental in making the partnership work because it will show publicly the commitment to

national growth and development in a country with a relatively weak private sector.

The government has put in place PEDSA, the country's Strategic Agriculture Plan for the period 2011-2020, and approved on 3rd May 2011 (PEDSA, 2013). The plan is clearly seeking to address the country's agricultural challenges: 1) low agricultural productivity, weak production and competitiveness of the sector; 2) limited access to markets due to poor infrastructure and supporting services; 3) land and forests mismanagement; 4) fragile institutions and incentives in the operationalization of strategic plans, programs and projects for the sector. According to the last agriculture census (2009/2010), there were 3.8 million farms in the country but the average farm was only between one and two ha, less than four percent of the total farms used fertilizer, only two percent had access to credit and around five percent used irrigation (INE, 2011). The PEDSA has 5 main goals: 1) a cumulative agricultural growth of at least seven percent annually; 2) double the agricultural production through productivity increase and expansion of cultivated land; 3) intensify cattle breeding and genetic improvement; 4) increase the production of poultry and 5) sustainable management of natural resources. While PEDSA gives a much more interventionist role to the government as a regulator and facilitator in the country's process of agricultural development it also intends to promote, attract and protect private investments in the whole value chain of the sector (PEDSA, 2013). The government is expected to: 1) increase expansion of rural extension services and agriculture research; 2) provide inputs needed for production and supply (like fertilizers); 3) offer technological packages, animal traction and mechanisation; 4) increase access to water, electricity and agro-processing; 5) guarantee credit for farmers, traders and suppliers; 6) invest in the provision of insurance; 7) expand contract farming and 8) return the country's marketing board, the Mozambique Cereals Institute (Instituto de Cereais de Moçambique) to its role of buyer of last resort (Hanlon, 2012). Korean firms,

jointly with its Portuguese and Mozambican partners, could share technical and technological expertise following the country's successful agricultural development and management within a context dominated by small-sized farms. Some major challenges that need to be taken into account in this sector. First, the issue of landgrabs and potential conflict with local communities that can easily emerge in mega agribusiness projects such as in the case of the Brazilian-Japanese-Mozambican funded ProSavana. And second, the need to carefully assess the political and bureaucratic interests of the ruling party in supporting *de facto* productive initiatives in this sector (Buur, Baloi and Tembe, 2012).

The government is also very interested in building a stronger domestic industry as a way to create jobs for the annual 300,000 job-seekers that enter the labour market. Despite the low rankings in the latest Ease of Doing Business and Global Competitiveness indexes, the Mozambican government continues to show signs that the expansion of the private sector, and in particular of export-oriented agro-industrial and labour-intensive industrial activities, is fundamental for the country's future development (Macauhub.com, 2013). As with the agricultural sector, the industrial sector is not free from problems. The Confederation of Mozambican Business Associations (CTA), together with the National Directorate for Studies and Policy Analysis (DNEAP) at the Ministry of Planning and Development and the National Statistics Office (INE), conducted an industrial survey covering 800 manufacturing SMEs in 7 provinces. While a final paper on this research is not available, John Rand and Soren Schou anticipate results (Rand & Schou, 2012). The main conclusion is that the most serious constraints to growth in Mozambican manufacturing are credit, access to land and corruption. An additional constraint that the authors highlight is the absence of skilled workers. Rand and Schou also mention the difficulties in expanding an export-oriented manufacturing sector: "Most manufacturers source inputs from abroad, and the

industrial sector in Mozambique is generally characterized by having a relatively low degree of sector linkages. Excluding megaproject exports, the contribution of the export sector to the Mozambican economy has been modest. The lack of diversity in manufacturing exports therefore raises concern about whether potential learning effects from exports (if present) have the necessary conditions for “spilling over” to the remaining economy”(Rand & Schou, 2012).

This analysis opens precisely the opportunity for Korean firms to offer their experiences in building, together with Portuguese and Mozambican firms, a successful export-oriented manufacturing sector; to the Mozambique government. Needless to say, that experience required overcoming many international obstacles. At the same time, Korean and Portuguese firms can be the vehicles to open markets for Mozambican manufactured products in Europe and Asia. For example, Mozambique already exports cotton and intends to increase its production under PEDSA. The existence of this abundant raw material could easily serve the needs of an infant textile manufacturing sector in Mozambique producing for the local, regional and global market. Recently, a consortium of Mozambican and Portuguese firms has bought the assets of the textile company Riopelle in Marracuene (30kms northern Maputo) and that had been inactive for 20 years. The new owners, Mozambican Intelec Holdings and Portuguese Mundotextil, Mundifios and Crispim Abreu, formed a new company called Mozambique Cotton Manufacturers (MCM) and announced an investment of USD 40 million for the next three years to revive textile production (Responsify.org, 2012). Also, Ethiopia can be a model for Mozambique. An increasing number of major global retailers such as H&M, Tesco or Primark have already started to source textiles and clothing from the country and the expansion of the industry has been due to increasing volume of cotton produced in the country (Textilesupdate.com, 2012). Finally, on the issue of lack of labour skills, the government has invested heavily in the past years in technical

and vocational training to answer the needs of the market (AfDB, OECD, UNDP and UNECA, 2012).

This innovative triangular business partnership between Korean, Portuguese and Mozambican firms is essentially a “learning-by-doing” initiative. In order to operate effectively, a crucial point that needs to be addressed from the beginning is the identification of common interests, ethics, business standards and complementarities of the business actors involved in the face of particular Mozambican political, economic and social context.

6. Conclusion

The challenges for investment in Mozambique are not few, which this paper has tried to highlight several times, but the rewards can be plentiful as revealed by the successful partnership between ENI (Italy), Galp (Portugal), Korea Gas Corp. (Korea) and state-owned oil company Empresas Nacional de Hidrocarbonetos ENH in discovering natural gas fields in the northern part of the country (oilreviewafrica.com, 2012). Apart from natural gas, Mozambique holds other abundant natural resources such as hydroelectric energy (that already exports to the region, in particular South Africa), coal, gold, titanium, bauxite and other minerals. It is one of the top ten countries with more land available for agriculture and its 2500 km coastline is known for the vast sea resources (McKinsey & Company, 2011).

Additionally, it is necessary to look at Mozambique beyond its wealth in natural resources. The country is responsible for 70% of goods transits of the Southern African Development Community (SADC). Its three logistic corridors

connect neighbouring landlocked countries to the world through the deep water coastal ports of Maputo, Beira and Nacala. Benefitting from a strategic location in the continent, Mozambique can be regarded as a base for entering a regional market (SADC) of 250 million potential consumers. SADC has been pushing for further trade and economic liberalisation in the sub-region and has put in place a Regional Indicative Strategic Development Plan (RISDP). This plan lays down a roadmap for SADC integration in several steps: a free trade area in 2008, a customs union in 2010, a common market by 2015, a monetary union by 2016, and an economic union with a single currency in 2018 (Kalenga, 2012). The volume of intraregional trade remains low at 19% of GDP but the prospects are positive following the consolidation of SADC free trade tariffs which began in 2008 (AfDB, OECD, UNDP and UNECA, 2012). Furthermore, Mozambique enjoys preferential access to European markets under the European Union/SADC Economic Partnership Agreement signed in 2009 as well as to the US market through AGOA. The adoption of a single electronic window “Janela Única Electrónica”, the electronic taxing system “e-tributação” and other internal electronic applications are expected to ameliorate customs performance and trade facilitation. Finally, World Bank’s Fengler states that the country is well placed to be one of the next middle-income African countries by 2025 if it continues on its current economic trajectory.

References

- African Development Bank, OECD, UNDP and UNECA. *Mozambique. African Economic Outlook 2012* (AfDB, OECD, UNDP and UNECA, 2012) available at <http://www.africaneconomicoutlook.org/fileadmin/uploads/aeo/PDF/Mozambique%20Full%20PDF%20Country%20Note.pdf>
- African Development Bank (AfDB). *The African Consumer Market* available at <http://www.afdb.org/en/blogs/afdb-championing-inclusive-growth-across-africa/post/the-african-consumer-market-8901/>
- AICEP, Relações Económicas Bilaterais com Moçambique 2007-2012 (Janeiro–Novembro). Available at <http://www.portugalglobal.pt/PT/Biblioteca/Pagina/s/Detalhe.aspx?documentId=dd564670-60a1-4db6-b83c-78d133c36f18>
- Anti-Corruption Resource Center U4, Overview of corruption and anti-corruption in Mozambique. *U4 Expert Answer Number 322* (Transparency International and Chr. Michelsen Institute, March 5, 2012) available at <http://www.u4.no/publications/PublicationSphinxSearchForm?PublicationSearch=mozambique&Category=&ThemeID=&Year=&Country=&SearchLocale=en-US&locale=en-US&action=publicationresults=Go>
- Ashoo, Guido. “Triangular Cooperation: Opportunities, risks and conditions for effectiveness.” *Development Outreach* (World Bank Institute, October 2010) available at <http://siteresources.worldbank.org/WBI/Resources/213798-1286217829056/ashoff.pdf>
- Buur, Lars, Obede Baloi and Carlota Mondlane Tembe. “Mozambique Synthesis Analysis: Between Pockets of Efficiency.” *DIIS Working Paper 2012:01* (Danish Institute for International Studies, 2012) available at <http://www.diis.dk/graphics/Publications/WP2011/WP2012-01-Mozambique-web.pdf>
- Cabral, Lília, Alex Shankland, Anna Locke and Jimena Duran. “Mozambique’s Agriculture and Brazil’s Cerrado ‘model’: Miracle or Mirage?” *Great Insights*, Vol. 1, Issue 10 (ECDPM, December 2012) available at [http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/\\$FILE/GREAT1-10final.pdf](http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/$FILE/GREAT1-10final.pdf)

- Chuhan-Pole, Punam, Manka Angwafo, Mapi Buitano, Allen Dennis, Vidjan Korman and Aly Sanoh. *Africa's Pulse*, Volume 6 (World Bank, October 2012) available at <http://siteresources.worldbank.org/INTAFRICA/Resources/Africas-Pulse-brochure-Vol6.pdf>
- CIP. *Base de Dados Empresariais* available at <http://www.cip.org.mz/cipsrcdb/index.asp?plus=true>
- Davis, Peter. "Let business do business: the role of the corporate sector in international development." *ODI Background Note July 2012* (ODI, 2012) available at <http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/7734.pdf>
- de Paepe, Gregory. "The Recent Natural Resource Hype in Mozambique: Putting it into Context." *Great Insights, Vol.1, Issue 10* (ECDPM, December 2012) available at [http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/\\$FILE/GREAT1-10final.pdf](http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/$FILE/GREAT1-10final.pdf)
- de Renzio, Paolo and Joseph Hanlon. "Contested Sovereignty in Mozambique: The Dilemmas of Aid Dependence." *Managing Aid Dependency Project GEG Working Paper 25* (University College Oxford, 2007) available at <http://www.globaleconomicgovernance.org/wp-content/uploads/Derenzio%20and%20Hanlon-Mozambique%20paper%20rev%20120107.pdf>
- de Tollenaere, Marc. "Mozambique: Ready for a Rollercoaster Ride?" *Great Insights*, Vol. 1, Issue 10 (ECDPM, December 2012) available at [http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/\\$FILE/GREAT1-10final.pdf](http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/$FILE/GREAT1-10final.pdf)
- Devarajan, Shantayanan and Wolfgang Fengler. "Is Africa's Recent Economic Growth Sustainable?" *Note de L'Ifri* (October 2012) available at <http://www.ifri.org/index.php?page=contribution-detail&id=7349>
- Dowden, Richard. "Africa: Image and Reality – wealth and poverty sit side-by-side (opinion)." *African Arguments* (8th January 2013) available at <http://africanarguments.org/2013/01/08/africa%E2%80%99s-image-and-reality-wealth-and-poverty-sit-side-by-side-%E2%80%93-by-richard-dowden>

- ECDPM. “Interview with President Armando Emilio Guebuza of Mozambique.” *Great Insights*, Vol.1, Issue 10 (ECDPM, December 2012) available at [http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/\\$FILE/GREAT1-10final.pdf](http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/$FILE/GREAT1-10final.pdf)
- EIU. *Mozambique Country Report*. The Economist Intelligence Unit (December 2012)
- EITI. Mozambique available at <http://eiti.org/news-events/mozambique-declared-eiti-compliant#>
- England, Andrew. “Portuguese seek future in Mozambique.” *The Financial Times* (18th March 2011) available at <http://www.ft.com/cms/s/0/84622634-6b66-11e1-ac25-00144feab49a.html#axzz2JGBOL6rd>
- Fengler, Wolfgang and Shanta Devarajan. *Africa’s MICs*. [blogs.worldbank.org: African Can...End Poverty](http://blogs.worldbank.org/AfricanCan...EndPoverty) (19th November 2012) available at <http://blogs.worldbank.org/africacan/africas-mics>
- Fine, David. “Inside Africa’s Consumer Revolution.” *Project Syndicate* (7 November 2012) available at <http://www.project-syndicate.org/commentary/inside-africa-s-consumer-revolution-by-david-fine>
- Fremantle, S. and J. Stevens. “EM10 and Africa: China-Africa – taking stock after a decade of advance.” *Africa Macro: Insight & Strategy* (Standard Bank, March 2012)
- Friends of the Earth Mozambique, Jubilee Debt Campaign and Tax Justice Network. *Whose development is this? Investigating the Mozal aluminium smelter in Mozambique* (Jubilee Debt Campaign, December 2012) available at <http://www.jubileedebtcampaign.org.uk/UK3720backed37203727development37273720factory3720costs3720Mozambique3720millions3720in3720lost3720taxes+8076.twl>
- Gonçalves, Ana Maria. REN e State Grid criam “joint venture” para mercado moçambicano, *Diário Económico* (28th December 2012) available at <http://economico.sapo.pt/noticias/ren-e-state-grid-criam-joint-venture-para-mercado-mocambicano-159239.html>

- Grain. "UNAC and Via Campesina Africa." *Brazilian megaprojects in Mozambique set to displace millions of peasants*, www.grain.org (November 29, 2012) available at <http://www.grain.org/article/entries/4626-brazilian-megaproject-in-mozambique-set-to-displace-millions-of-peasants>
- Hanlon, Joseph. "Mozambique in Andreas Mehler." Henning Melber and Klaas Van Walraven, eds. *Africa Yearbook: Politics, Economy and Society South of the Sahara in 2011*, Volume 8 (Brill 2012) available at <http://www.open.ac.uk/technology/mozambique/pics/d137044.pdf>
- _____. "FRELIMO Balances Keep President Guebuza in Check: Party congress secures power sharing." NAI FORUM (31st October 2012) available at <http://www.naiforum.org/2012/10/frelimo-balances-keep-president-guebuza-in-check>
- _____. *Mozambique's elite – finding its way in a globalised world and returning to old development models*. Paper presented at LSE Crisis States Research Centre Seminar (October 2009) available at http://www2.lse.ac.uk/international_Development/research/crisisStates/download/seminars/Hanlon%20-%20Mozambique%20elite%20capitalism%20-%20Sep09.pdf
- _____. ed. "Mozambique News reports & clippings." *Newsletter*, No. 210 (28 December 2012) available by subscription only with the author
- Hattingh, Damian, Bill Russo, Ade Sun-Basorun and Arend Van Wamelen. "The rise of the African consumer. *McKinsey's Africa Consumer Insights Center* (McKinsey&Company, October 2012) available at <http://www.mckinsey.com/global-locations/africa/south-africa/en/rise-of-the-african-consumer>.
- Hofmann, Katharina and Adrian de Souza Martins. "Descoberta de Recursos Naturais em Moçambique: Riqueza para poucos ou um meio para sair da pobreza?" *Perspectiva/FES Moçambique* (Friedrich Ebert Stiftung, Agosto 2012) available at <http://library.fes.de/pdf-files/iez/09356.pdf>
- INE. "Censo Agrário 2009-2010." (Maputo, November 2011) available at www.ine.gov.mz

- IMF. *Mozambique: Letter of Intent* (IMF, December 7, 2012) available at <http://www.imf.org/External/NP/LOI/2012/MOZ/120712.pdf>
- IMF. “Republic of Mozambique: Fifth Review Under the Policy Support Instrument and Request for Modification of Assessment Criteria.” *IMF Country Report No.13/1* (IMF, January 3, 2013) available at <http://www.imf.org/external/pubs/ft/scr/2013/cr1301.pdf>
- Jerven, Morten. “Quizzing African GDP stats.” *This is Africa* (17th December 2012) available at <http://allafrica.com/stories/201212180891.html>
- Kalenga, Paul. “Regional Integration in SADC: retreating or forging ahead?” Tralac Working Paper No S12WP08/2012 (Tralac Law Centre, September 2012) available at <http://www.tralac.org/files/2012/09/S12WP082012-Kalenga-Regional-integration-in-SADC-retreating-or-forging-ahead1.pdf>
- Kang, G.S. “The Korea-Africa Partnership: Beyond Trade and Investment.” *Africa Economic Brief* 2 (9) (AfDB, 2011) available at <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/AEB%20VOL%202%20Issue%209%20June%202011-AEB%20VOL%202%20Issue%209%20June%202011.pdf>
- Kim, So-hyun. “Korea’s trade tops \$1 tr for first time.” *The Korea Herald* (5th December 2011) available at <http://nwww.koreaherald.com/view.php?ud=20111205000665>
- KITA. *Korean International Trade Association* available at www.kita.net
- KOICA. *Korean International Co-operation Agency* available at www.koica.go.kr
- KOAFEC. *Korea Africa Forum for Economic Cooperation* available at www.koafec.org
- Kring, Thomas. “Mozambique and the Human Development Index (HDI) 2011.” *Economic and Policy Analysis Unit Brief No: 01/2011* (UNDP Mozambique, 2011) available at <http://www.undp.org/mz/pt/Publications/National-Reports/Mozambique-and-the-Human-Development-Index-HDI-2011>
- Lusa. “Governo moçambicano admite “mais zelo” na distribuição de vistos.” *Público* (17th January 2013) available at <http://www.publico.pt/sociedade/noticia/>

- governo-mocambicano-admite-mais-zelo- na-distribuicao-de-vistos-1581035
- Lusa. “Moçambique Compra Posição da CGD no Banco Nacional de Investimentos.” *Público* (10 December 2012) available at <http://www.publico.pt/economia/noticia/mocambique-compra-participacao-da-cgd-no-banco-nacional-de-investimentos-1576871>
- Macaubub.com. “Moçambique Aposta na Indústria para Criar 216 mil postos de trabalho.” *Macauhub.com* (28th January 2013) available at <http://www.macaubub.com.mo/pt/2013/01/28/mocambique-aposta-na-industria-para-criar-216-mil-postos-de-trabalho>
- Malin, Paul. “EU support to Mozambique.” *Great Insights*, Vol.1, Issue 10 (ECDPM, December 2012) available at [http://www.ecdpm.org/Web-ECDPM/ Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/\\$FILE/GREAT1-10final.pdf](http://www.ecdpm.org/Web-ECDPM/ Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/$FILE/GREAT1-10final.pdf)
- McKinsey & Company. *See Lions on the Move: The Progress and Potential of African Economies* (McKinsey Global Institute, 13 September 2012) available at <http://www.mckinsey.com/insights/mgi/research/productivity-competitiveness-and-growth/lions-on-the-move>
- Mosca, João and Tomás Selemane. *El dorado Tete: os mega projectos de mineração* (CIP, 2011) available at <http://www.cip.org.mz/cipdoc%5C106-EL%20DORADO%20TETE-Mosca%20e%20Selemane-CIP-2011.pdf>
- Mubila, Maurice, Mohamed-Safouane Ben Aissa and Charles Leyeka Lufumpa. “The Middle of the Pyramid: Dynamics of the Middle Class in Africa.” *AfDB Market Brief* (AfDB, April 20, 2011) available at <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/The%20Middle%20of%20the%20Pyramid-The%20Middle%20of%20the%20Pyramid.pdf>
- Oilreviewafrica.com. “New natural gas discoveries made in Mozambique.” *oilreviewafrica.com* (5th December 2012) available at <http://www.oilreviewafrica.com/gas/gas/new-natural-gas-discoveries-made-in-mozambique>

- O País. “Estado Moçambicano Passa a Controlar 100% do BNI.” *O País* (11 December 2012) available at <http://www.opais.co.mz/index.php/economia/38-economia/23339-estado-mocambicano-passa-a-controlar-100-do-bni.html>
- O País. “A Segunda Fase das Nacionalizações.” *O País* (14 December 2012) available at <http://www.opais.co.mz/index.php/economia/38-economia/23378-a-segunda-fase-das-nacionalizacoes.html>
- PEDSA. available at <http://www.open.ac.uk/technology/mozambique/pics/d130876.pdf>
- Pitcher, Anne. “Recreating Colonialism or reconstructing the state? Privatization and politics in Mozambique.” *Journal of Modern African Studies*, 22:1:49-75. (March 1996)
- Polgreen, Lydia. “As Coal Boost Mozambique, the Rural Poor Are Left Behind.” *The New York Times* (November 10, 2012) available at <http://www.nytimes.com/2012/11/11/world/africa/as-coal-boosts-mozambique-the-rural-poor-are-left-behind.html?pagewanted=all&r=0>
- Rádio Moçambique. *Governo Vai Renegociar Mega-Projetos* (27 de Dezembro de 2012) available at <http://www.rm.co.mz/index.php?option=com-content&view=article&id=6424:governo-vai-renegociar-mega-projectos&catid=1:ultimas&Itemid=50>
- Ramdoo, Isabelle, Mozambique. “Aid and Foreign Investment: Trapped between Scylla and Charybdis?” *Great Insights*, Vol.1, Issue 10 (ECDPM, December 2012) available at [http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/\\$FILE/GREAT1-10final.pdf](http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/$FILE/GREAT1-10final.pdf)
- Rand, John and Soren Schou. “Has the Business Environment in Mozambique Improved During the Past 10 Years?” *Great Insights*, Vol.1, Issue 10 (ECDPM, December 2012) available at [http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/\\$FILE/GREAT1-10final.pdf](http://www.ecdpm.org/Web-ECDPM/Web/Content/Download.nsf/0/C9912335D7E74BBCC1257AD4002D349B/$FILE/GREAT1-10final.pdf)

- Responsify.org. "Mozambique: Investment of 40 million dollars for Riopole textile factory," *Responsify.org* (1st November 2012) available at <http://www.responsify.org/nyhet/mozambique-investment-of-40-million-dollars-for-riopole>
- Rowden, Rick. "The Myth of Africa's Rise." *Foreign Policy* (4th January 2013) available at <http://www.foreignpolicy.com/articles/2013/01/04/the-myth-of-africa-s-rise>
- Silva, Nuno Miguel. "Portucel arranca com investimento na nova fábrica de Moçambique." *Diário Económico* (31st August 2010) available at <http://economico.sapo.pt/noticias/portucel-arranca-com-investimento-na-nova-fabrica-em-mocambique-97985.html>
- Textileupdate.com. "See Ethiopia Textile and Clothing Market Growing." *textileupdate.com* (17th December 2012) available at <http://textileupdate.com/ethiopia-textile-and-clothing-market-growing>
- The World Bank. *Global Economic Prospects: Assuring growth over the medium term*, Volume 6 (January 2013) available at <http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1322593305595/8287139-1358278153255/GEP13aSSARegionalAnnex.pdf>
- The World Bank. *Ease of Doing Business* available at <http://www.doingbusiness.org/data/exploreeconomies/mozambique/>
- The World Bank. *Economics of Adaptation to Climate Change: Mozambique* (World Bank, 2010) available at <http://climatechange.worldbank.org/sites/default/files/documents/EACC-Mozambique.pdf>
- Transparency International. *Corruptions Perception Index* (2012) available at <http://www.transparency.org/cpi2012/results>
- UNAC. *Pronunciamento da UNAC sobre o Programa ProSavana*, www.unac.org.mz (UNAC, Outubro 2012) available at <http://www.unac.org.mz/index.php/7-blog/39-pronunciamento-da-unac-sobre-o-programa-prosavana>

UNDP. *African Human Development Report 2012: Towards a Food Secure Future* (UNDP, 2012) available at <http://www.undp.org/content/undp/en/home/librarypage/hdr/africa-human-development-report-2012/>

Whitehead, Eleanor. “Sub-Saharan sovereigns: who to watch in 2013.” *This is Africa* (December 19, 2012) available at <http://www.thisisafricaonline.com/News/Sub-Saharan-sovereigns-who-to-watch-in-2013?ct=true>

WEF. *Global Competitiveness Index* available at <http://reports.weforum.org/global-competitiveness-2011-2012>

The Second-Tier “Tigers” in the Light of Latin American Experience

Victor Krasilshchikov¹⁾

1. Introduction: “Unhappy” Latin America and “Lucky” East Asia

Many Latin American economists and sociologists treat their countries as global losers and compare them to the East/Southeast Asian “tigers”. Contrasting the two regions to each other became a kind of intellectual vogue since the 1980s when Latin America underwent serious disturbances of “the lost decade” (“la década perdida”), whereas the newly industrialising countries (NICs) of East and Southeast Asia became a success story.²⁾ Fernando Fajnzylber was one of the first scholars who focused on the juxtaposition of the two developing regions to each other in his pioneering work (Fajnzylber 1983: 103-147). Later, he treated the results of Latin American development as the “empty box” (el “casillero vacío”)

1) Victor Krasilshchikov works at the Institute of World Economy and International Relations (Russian Academy of Sciences), Moscow, where he is head of research group of the Centre for Development and Modernisation Studies. In addition, he is convener of the working group “Transformations in the World System - Comparative Studies of Development” of EADI (European Association of Development Research and Training Institutes), Bonn.

2) “East Asia” refers herein to East and Southeast Asia together.

apart from the industrial development achievements of the Asian NICs (Fajnzylber 1990a: 151-163; 1990b: 147-159).

The Asian financial crisis of 1997-98 tempered the enthusiasm of researchers who compared the development stories of the two regions with each other; nevertheless, they continued comparing Latin America as the 'loser' to a 'lucky' East Asia. For example, José Gabriel Palma marked the permanent technological upgrading of exportable goods as one of the main sources of East Asian success in contrast to the development of Latin America which "ameliorated its competitiveness in the line of traditional products" (Palma 2006: 258) but did not promote the outward-looking industrial branches with a high level of value added (i.e. technologically complicate) (Ibid.: 250-254, 260-278). Pierre Salama, the French economist specialising in the comparative studies of development, explains the East Asian accomplishments through better adaptability of the "tigers" to the global demand and, also, notes the more egalitarian character of their economic growth (Salama 2006: 51-72, 145-149).

At last, it is worth noting that a comparative analysis of Latin America and East Asia continued to be in a focus of CEPAL/ECLAC.³⁾ Just before the global crisis of 2008-09, ECLAC published the document which compared Latin America with East Asia mostly from the perspective of innovations and scientific-technological potential. The Asian NICs were much more successful in this regard than their Latin American counterparts, although the authors in this publication did not assess the results of the Latin American development in the last twenty years as merely the "empty box" (CEPAL 2008: 56-57, 76-78, 101-103). One of the latest reports issued by CEPAL/ECLAC observed a broad complement of various development aspects and comparing again the "empty box" of Latin America with the "full coach" of East Asia. Its authors emphasized the development in South Korea; marking *the zero growth* of the total factor productivity in Latin

3) ECLAC - the United Nations Economic Commission for Latin America and the Caribbean. CEPAL is Spanish acronym of this abbreviation.

America as a whole whereas this indicator had grown 3 times in East Asia over the last three decades (1980-2010) (CEPAL 2012: 42-44). According to them, this fascinating productivity increase has been conditioned by the subsequent structural changes and technological improvements which did not occur in Latin America, at least, in a comparable scale (Ibid.: 77-80, 107-112), and it is treated as the main factor of the Asian growth's sustainability which enables to the "tigers" to smooth the cyclical fluctuations.

Meanwhile, it seems to be relevant to pose the following question: Are there some similarities between the "unhappy" development story of Latin America, on the one hand, and the "lucky" industrialisation of East Asia, on the other, behind the known differences between them? The next section of this paper is devoted to clarification of this issue. Anticipating its consideration, it is necessary to note that either of the developing regions under scrutiny has to be considered in the real world context, including the Cold War and the processes that took place in the developed countries which make up the core of the world economic system.

The third section contains a brief observation of the Brazilian and Chilean experience of authoritarian, elitist modernisation that intended to fulfill the blind technocratic belief in omnipotence of market and advanced techniques in providing for economic growth and to resolve all social problems. Such an observation facilitates comprehending some hidden difficulties built into the social-economic mechanism of the "tigers" development. Particularly, it concerns the second-tier "tigers" which are the focus of our analysis.

The fourth section deals with the rise of the "tigers" economies, mainly the second-tier ones (Malaysia and Thailand). It is treated from the viewpoint according to which the East Asian successful development was a kind of *dependent development* and, furthermore, posits that its success has been the main cause of the 1997-98 debacle. In other words, the "tigers" success story is taken as the premise of the *modernisation trap* situation, where the East Asian NICs found themselves in the late-1990s.

The fifth and sixth sections consider the aftermaths of the 1997-98 and 2008-09 crises, respectively, in Malaysia and Thailand. The right conclusions from those meltdowns notwithstanding, the ruling circles in these countries did a little to assure deliverance from vulnerabilities that were inherent to their development model. In particular, the scientific-technological capacities of the second-tier "tigers" continue to be weak; impacting their competitiveness which suffers from the Chinese trade expansion. The latter leads to a worsening of the external trade structure of the countries under consideration. At the same time, all attempts to elevate their economies in line with advanced technologies fail because of resistance to renewals from the side of bureaucracies as well as from the large internal economic peripheries. This resistance, whether it is voluntary, conscious or, on the contrary, involuntary, has been combined with a technocratic approach of the ruling political elites to scientific-technological development (like in the case of Brazil in the 1960s-80s) and impedes whatever transition towards a post-industrial, knowledge-based economy. Thereby, the "tigers" run the risk of following many Latin American countries remaining in "a middle-income trap" though it is only one particular case of a modernisation trap situation.

In conclusion, it will be demonstrated what is currently being called a transition to a new stage of development is hardly possible without abolishing the internal periphery. In other words, the *social* development becomes the imperative for the "tigers", including their first, apparently more fortunate generation (Hong Kong, Singapore, South Korea and Taiwan province).

2. Comparing Latin America to East Asia: Visible Differences and Hidden Similarities

A comparison of an "unfortunate" Latin America to a "lucky" East Asia with the seemingly inevitable conclusion about superiority of the Asian NICs to Latin

American countries has mostly been concentrated on visible, superficial aspects of their development. Indeed, it is not difficult to compare them with each other, using the well-known quantitative indicators, such as the rates of GDP growth, productivity, the rate of investment, incomes' distribution in the process of industrialisation, the rate of literacy among their populations, etc. However, there are also the qualitative aspects, which concern the intrinsic mechanism as well as the external and internal factors of development.

At first, the both regions approached to their modernisation under impact of the external factors and challenges rather than because of the internal impulses and premises for their social-economic and political renewal. Even in the most developed countries of Latin America (Argentina, Chile and Uruguay, to a lesser degree, Brazil) where the internal preconditions for endogenous capitalist development (=modernisation) existed and matured properly, the economic challenges from abroad played a much more important role in the process of industrialisation⁴⁾ than some springs of industrial capitalism that began emerging there since the second half of the XIX Century. In the case of East Asia, a set of the external factors which influenced the internal situation was also the reason for profound changes, when the small, poorly industrialised countries of the region initiated their economic spurt in the 1960s. Thus, an industrial modernisation in both Latin America and East Asia began when their populations were neither economically nor psychologically ready to enter the stage of wide-scale industrialisation and urban life.

Secondly, a compulsion to modernize mostly under pressure of the external circumstances conditioned the conservative character of modernisation (Krasilshchikov 2008: 39-49, 68-74, 197-221, 325-328; Krasilshchikov 2013: 167-169). It meant an inevitable compromise between traditions and values of modernity, between adherence of most people to their customs and non-desire to

4) It was due to the import substitution industrialisation aimed at deliverance from the external economic dependency on the world market that the demand for Latin American commodities had drastically fallen in the years of the Great Depression.

change their everyday lives, on the one hand, and endeavour to modernise an economy and social life, on the other. Moreover, the large majority of the local elites thought of modernisation as the only way to save their dominant positions and privileges by adapting several elements of modernity to their narrowly egoistical needs and interests. In other words, a modernisation has been perceived by elites as the key to survival in the changing world and to preserve themselves from social death.⁵⁾

At the same time, the abovementioned compromise enabled to modernisers (main actors of modernisation) to adopt the values and principles of modernisation in a manner mostly appropriate for ordinary people. In particular, the slogans involving the revival of Confucian doctrine (the cases of Singapore, Taiwan and South Korea in the 1960s – early-1990s) reconciled East Asian culture and traditions with fast modernisation in relatively painless manner for the vast majority of ordinary people. It stabilised society during conditions of rapid change and attributed an additional dynamism to the process of transformation, particularly, at the initial stages.

However, how long could this compromise between traditions and modernity work while not posing obstacles to further development? Supposedly, it played a significant role in creating situations where the “tigers” found themselves in distress (1997-98).

A similarity between Latin America and East Asia on such important issues as the leading role of external factors in their modernisation and the latter’s conservative character allows us to ask the question as to how profound are differences between them. Furthermore, it is also relevant to presuppose that the direction of development of both regions under scrutiny converge with each other.

Moreover, from the perspective of developmental *modus operandi*, the

5) For example, such were the cases of Germany under Bismarck, Japan in the Meiji period, Russia under the tsars. Brazil under the first rule of Vargas (1930-45) gives us the XX Century example of a conservative modernisation when the old oligarchy was obliged to agree with the rapid capitalist development for the sake of social survival.

essential common feature of Latin American and East Asian development, beginning, at least, from the mid-1960s to the mid-1990s, consisted in its *associated-dependent character*. Their development paths depended on the processes in the core of the world system.

Actually, it is difficult to understand the Latin American and East/Southeast Asian development stories, firstly, if we were to ignore the world economic and political contexts existed in the second half of the XX century, including Cold War, secondly, ignoring the proper interests of local elites and the social conflicts in respective countries.

The 1960s, when the first-tier “tigers” were about to initiate accelerated modernisation, were the time of new opportunities, and choices as to modes of the world development depended on personal qualities of people responsible for taking the principal decisions to much bigger degree than, probably, whenever after the Second World War. Unfortunately, as it has often been occurred in history, the real trajectory of the world development was chosen because it appeared as the easiest for realisation; but “the easiest” did not mean “the best” (by the way, “the best” for whom?).

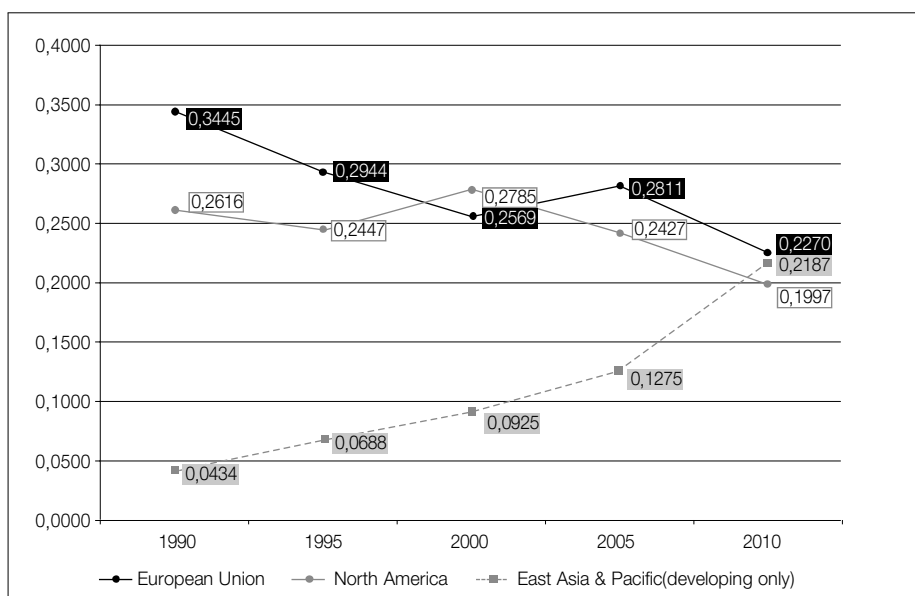
At that time, late-industrial (=Fordist-Keynesian) capitalism with the welfare state reached its objective limit. Simultaneously, the import substitution industrialisation and the populist policy as well in the most developed Latin American countries came to a dead end, too. The wave of acute social conflicts rose, threatening to spread over the whole continent. In Asia, leftist movements, often under the direct pro-Maoist leadership, disturbed the US and their local allies. Then the strategic interests of the core countries’ capital (*prima facie*, of the US), the national bourgeoisie, the old (but modernised!) oligarchy and bureaucracy in Latin America and East Asia had coincided with each other in the face of the common threat. A necessity to respond to this threat, and subsequent desire to search for solutions, was stronger and more important than conflicts and controversies among participants of this new accidental alliance.

The capital holders in the core of the world system were concerned about: a) the new fields for investment, more profitable than at home, preferably abroad where there was some social-economic base for its activity, including an appropriate labour force; b) the ways of delivering of themselves from home manufacturing industries that had become ineffective. The national capital in the most developed Latin American countries, together with the most "progressive" oligarchic groups, as in the case of Brazil or Argentina, intended to implement the mass consumption society, considering the latter as the best way to neutralise the radical Leftists and to prevent the Cuban-type revolution. At last, an amorphous conglomerate of different social groups in East Asia also developed a panic fear of the Soviet and/or Chinese intrusion into the region but only narrow elite could canalise and steer them towards resolving acute problems via modernisation.

Thus, in the 1960s, particularly, in the second half of the decade, there was a time when the persistent necessity as well as the social actors of profound modernisation emerged in several parts of the then-Third World. Apart from the previous stages of relations between the core and peripheral countries, the industrial capital in the core now became interested in investing in manufacturing industries at the erstwhile periphery. Thereby, it (the industrial capital – V.K.) pursued expansion of the internal markets there as well as production of exportable manufactured goods that would be competitive in the markets of developed countries. This new situation added a new dimension to dependency. The scientific recognition of this phenomenon became the most essential (but not the only!) element of *the associated-dependent development* conception formulated by Fernando Henrique Cardoso and Enzo Faletto (Cardoso 1972: 88-94; Cardoso 1973: 144-149; Cardoso, Faletto 1970: 135, 144-150; Cardoso, Faletto 1978:150, 159-164).⁶⁾ This conception, being initially elaborated for Latin American countries, mostly Brazil and Mexico, nevertheless possessed a universal character because

6) Almost forty years after the first publication of their joint book, F.H. Cardoso especially focused on this element of the concept (Cardoso 2007: 218-219).

Figure 1. The share of value added in the world manufacturing industry, by region, 1990-2010 (total value added by manufacturing industry in the world = 1.000)



Source: the author's calculations based on the World Bank database (the data on value added in manufacturing industry at current market prices in US\$).

the rise of manufacturing industries upon the base of foreign investment could take place anywhere, not only in Latin America but also in Asia and Africa. Cardoso underlined an applicability of his and Faletto's brainchild to all developing regions (Cardoso 1972: 88).

It was notable that the concept did not raise *dependency* to the rank of absolute, insurmountable obstacle to development. It recognised the availability of socioeconomic space and opportunities for *development from within* as well as internal obstacles to development rooted in social-economic structures, attitudes of various influential groups, etc, in the peripheral countries. It did not intrinsically exclude the potential for a situation where the efforts of local elites in one or another peripheral country aimed at modernisation could fortunately coincide with

the intentions of the core countries' capital forces to find the field for advantageous investment. Such a coincidence actually took place in East Asia.

According to the idea of associated-dependent development, a dependency of a country's development on external forces (factors) does not exclude a possibility of rapid economic growth together with progressive structural changes in its economy. The following diagram (diagram 1) illustrates how the share of the East Asian developing countries (including China) in the world manufacturing industry's value added increased from 1990 to 2010 whereas the share of European Union and North America declined.

However, neither the fascinating growth of manufacturing industry nor the successful adoption of new technologies eliminated dependency of the Asian NICs on the core countries, mainly the US and Japan. Not being fixated on numerical indicators of the East Asian growth since the 1960s, we have to take into account what *quality* of that growth has been and whether this growth has yet to provide for Asia's superiority to the West in the most contemporarily advanced industries, sciences and technologies or not. Supposedly, any serious attempt to reply to these and concomitant questions would allow us to cast doubt on "re-orienting" of the world-system core to eastwards, as Andre Gunder Frank asserted (Frank 2005: 215-217, 223-227). Today, it is still, at least, too early to speak of a relocation of the world-system's centre to Asia, the obvious global shift of material production and wealth to east- and southwards notwithstanding. Of course, if the Asian countries do become the world's scientific and technological leaders in the future, they will definitely obtain superiority vis-à-vis the West. As of now, the East took only the initial, first steps in moving in this direction; the recent situation, in addition to problems plaguing the "tigers" as well as China and India, shows that such a prospect is far from inevitable. Moreover, the new process has been emerging in the last two years: some technologically complicated manufacturing industries are returning to their historical motherland, the developed countries of the West. It is happening principally based upon new technical processes: robotisation, computerisation, etc. (Fishman 2012; Markillie 2012).

This phenomenon underscores how the East Asian “miracles” have been dependent on and vulnerable to the global economy’s fluctuations. Does it not presume that the “tigers”, at least, the “youngest” of them, will involuntarily repeat the same experience which some Latin American countries underwent in the past, despite the apparent development success in several periods in their contemporary history?

3. “A Santa Fé” Tecnocrática: The Brazilian Experience and Its Implications

Among all attempts to carry out the accelerated modernisation in Latin America in the last third of the 20th century, the cases of Chile and Brazil under the aegis of the military-bureaucratic authoritarian regimes have been the most visible.⁷⁾

The Chilean story started out with many thousands of people being killed and tortured by police and army of Pinochet junta before it attained achievements from implementation of the free market institutions. In this respect, the regime of Pinochet was one of the most curious pupils of the IMF and such liberal economists as Milton Friedman and Friedrich von Hayek. However, aside from the victims sacrificed for the economic “miracle”, the cost of profound economic reform has been the country’s decline in terms of technological sets. In other words, the Chilean authoritarian modernisation renovated and improved the old branches of economy that corresponded to the first big (Kondratiev) cycles, such as

7) The term “military-bureaucratic authoritarianism” was introduced by Guillermo O’Donnell to signify a uniqueness of the regimes established in Brazil and Argentina in 1964 and 1966, respectively. In spite of their repressive character, these regimes were not the same as the traditional dictatorships well-known in the continent. It was necessary to highlight its peculiar features, including such ones as endeavour to carry out the new accelerated modernisation (O’Donnell 1973). Later, this term was picked up and developed in detail by other scholars, including F.H. Cardoso, José Serra, David Collier, etc. (Cardoso 1977: 24-25, 50-82; Cardoso 1979; Collier 1979: 19-32; O’Donnell 1979, Serra 1979).

alimentary, paper manufacturing, construction materials and light (textile and footwear) industries (except, perhaps, the chemical industry that pertained originally to the late-industrial stages of economic development), not mentioning, of course, about the copper-mining industry. These branches became competitive in the external markets and played the role of engines for the Chilean economy as a whole but their achievements had very strong negative effects – the deepening social stratification and impoverishment of the large masses of working people. Such was the price of success.

The Brazilian military-bureaucratic authoritarianism demonstrated less visible achievements in liberalisation of economy than its Chilean counterpart did. The economic role of the state in Brazil was always very important since the 1930s when the import substitution industrialisation started under the rule of Gétúlio Vargas. However, the Brazilian regime was the most successful among all Latin American authoritarianisms of the second half of the past century in promotion of new technologies and branches of manufacturing industry.

The Brazilian authoritarian regime that was established in 1964 proclaimed the modernisation and transformation of the country into a fully developed nation as its long-term strategy. According to the regime's leaders, achievement of this goal was the best way to prevent the potential "turn to the Left" and to preserve the country from "the Communist threat". (The people who organized the coup d'état of 1964, as well as their US "supervisors", including the American ambassador Lincoln Gordon, exaggerated a possibility of "the Leftward shift" in Brazil because of their fear of the new *Cuban-type revolution*).

In reaching the announced goal, the regime encouraged local and foreign entrepreneurs to invest in new branches of economy and to implement technological innovations, opened doors to the multinational corporations (MNCs) that developed manufacturing industries and brought new technologies, established the national research centres and supported vocational as well as special engineering education. Under the military-bureaucratic authoritarianism, Brazil became the country with a proper aircraft industry, nuclear power stations, space research and capable of

nationally-based production of computers (It is worth to remind, in this connection, that Brazil has been the second country in the world, beyond the US, which constructed a personal computer in 1979, only three years after the rise of “Apple”). At the same time, the regime oppressed any resistance to its policy, particularly, from the Left and trade unions, maintaining “political stability” and restricting all protests against diminishing wages. Thereby, it provided the favourable conditions for the foreign investors in Brazil.

The military-authoritarian leaders of Brazil and their civil technocratic allies believed that any promotion of new technologies and accelerated growth of advanced manufacturing industries would be the main keys to the country’s economic development as a whole. According to such approach to tempering the acute social-economic problems that tormented Brazil, it would be sufficient to support several “islands of the future”, using state power for the “compulsion to modernisation” and thus subject the “backward part” of the society to scientific-technical “rationality”. All the rest should be done by the market forces operating through “the demonstration effect” that would lead Brazil to prosperity.

This was a type of technocratic belief in the omnipotence of managerial state power, on the one hand, and in universalism of market forces, on the other. Such belief was accompanied by idolisation of technology and scientific-technological progress as a whole and formed the backbone of all social-economic policy of the Brazilian regime over twenty years, from 1964 to 1985, when it was forced off the political scene. It, obviously, had a flip side, of disdain for workers who had been treated as a faceless mass. As Florestan Fernandes, one of the founding fathers of Brazilian sociology, demonstrated in his works, this approach was inherited from the colonial times (Fernandes 2008: 85-86) when the Portuguese nobles conceived slaves and peasants only as “speaking tools” of labour. Therefore, the regime’s ostentatious technocratism was a form of conservatism. The latter was indistinguishable from the interests of social groups that made up the main base of the regime. Among these groups, there were the most “advanced” parts of the old agrarian oligarchy integrated into the capitalist development, the top

state bureaucracy, military and civil, and the cosmopolitan bourgeoisie, including a large part of the upper-middle class. Intentions of these social groups consisted in strengthening and improving the old social system by adapting it to the new challenges. It inevitably lent a conservative character to modernisation when the old, obsolete social-economic system mimicked and borrowed outward forms of the progressive changes without profound transformation (Ferraz 1990: 9).

The growth spurt of the Brazilian economy began in 1967, after a period of economic and political stabilisation. It lasted till 1974 and was marked by the phenomenal growth, particularly, in industries producing the technically sophisticated durable consumer goods. Economists and politicians spoke about the new "miracle" in Latin America. However, this "miracle" deepened the gap between rich and poor, being advantageous mostly for the upper 25-30 per cent of the country's population. The rest of Brazilians could hope only for spontaneous trickles of the modernisation diffusing into the lower strata, and actually the share of the poor decreased slowly, much slower than growth rate of the GDP. It fell from 49 percent of all households in 1970 to 39 percent in 1979, whereas the GDP per capita increased almost two times over the same decade (CEPAL/ECLAC 1993: 45, 68-69). The mass poverty and shocking inequality continued being the character features of Brazilian society even when the national pie increased rapidly. The regime did not ignore these problems. Beginning from 1970, under presidency of Emílio Garrastazo Médici, the state augmented the expenditures for social needs, including funding to reduce adult illiteracy. But these efforts were evidently insufficient, as they were not concerned with the internal structure of the economy and directions of investment flows, and therefore, did not facilitate the rise of new occupations. In particular, the social policy of the regime had no meaningful link to agrarian reforms. The authorities encouraged peasant migration into the depths of Amazonia but did almost nothing to abolish the dualism of latifundias/minifundias in existing agricultural sector. It conserved the countryside's archaic social relationships based on patrimonialism. Thus, the real social-economic policy contradicted the ostensible strategic goal: the low wages and incomes of

a vast majority of people were incompatible with the regime's intentions to build a mass consumption society such as in developed countries. When the military regime was ousted (1985), 29.3 per cent of the working people (42.9 per cent – in rural areas) earned less than the minimal salary, 22.5 per cent – between one and two minimal salaries, 12.9 per cent of the economically active population had no income at all. Therefore, about two thirds Brazilians lived in poverty, existing outside of the boundaries of the purported economic “miracle” (Jaguaribe e. a. 1986: 17-18, 41-44, 69).

A deep social inequality and mass poverty put obstacles in the way of innovations and devalued all efforts of the enlightened autocrats to instigate scientific-technical progress. A majority of entrepreneurs hired workers with minimal needs and poor skills instead of worrying about the implementation of new technologies. The attempts to compensate for the lack of incentives to innovate by increasing investments, in particular with borrowed resources (the debt-led growth!) did not resolve the problem. In the long-term perspective, it negatively impacted the rate of profits and consequently diminished the effectiveness of the Brazilian industry as a whole (Gaulard 2011: 178-185; Marquetti 2004: 11-14). In the conditions of openness to the world economy, when banking interest rates rose drastically because of the monetarist policies of Thatcher and Reagan (the early-1980s), investments in financial sphere started to become more advantageous than investments in industry.

In fact, the authoritarian, elitist modernisation in Brazil aggravated the socio-economic and socio-cultural dualism of modernity and traditionalism inherent to Brazilian society from the colonial times. Thereby, it reproduced the old obstacles to development instead of abolishing them. The large areas of poverty and backwardness constrained the expansion of the market and ensured that the labour force would remain poor in quality. In addition, the poverty demoralised the lower classes and stoked their resistance, albeit passive, to any progressive changes in the country. Thus, the elitist character of modernisation perpetuated the lower classes' conservatism, much stronger in many respects to that of the old upper

classes. It was the main cause in the Brazilian economy shining bright for a very short time, for less than ten years, and rapidly declined at the end of the 1970s. Taxed by the internal problems, Brazil as well as other Latin American countries suffered much from its vulnerability to the double external blows: 1) the financial globalisation that aggravated the problem of indebtedness; 2) depreciation of the national exports, partly because of the new technological revolution (the latter facilitating implementation of the energy- and resources-saving technologies in the West), partly due to the strong competition with the young Asian "tigers" for markets of manufactured goods. Brazil, together with her neighbours and counterparts in the continent, could not avoid *the lost decade* of the 1980s and underwent difficulties of inflation, recession and deindustrialisation.

The experience of Brazil in the years of authoritarian modernisation clearly demonstrated that modernisation cannot be successful if it does not resolve social problems or alleviate the internal dualism of modernity and traditionalism in economy and society. Nonetheless, we are currently witnessing tendencies in various countries to repeat involuntarily the negative experience of Brazil. These can be seen, in particular, in some Asian NICs which have been regarded as the patterns of success for Latin America.

4. The Second-tier "Tigers" from the Rise to Distress (1970s – 1997)

The rise of the Asian NICs was the effect of combination and coincidence of many factors, and this combination has been unique in history. It is difficult to presuppose that something similar will emerge in the world again in the foreseeable future.

In the 1960s, at the dawn of East Asian "miracle", the nations of the region faced many challenges, which threatened their existence, not only politically but also even in a physical sense.⁸⁾ In particular, there was the triangle of confrontation

between the US, USSR, and Maoist China; vying with each other for domination in the region. From the point of view of the local ruling elites, it was preferable to stay under military-political umbrella of the West than to be pulled into the sphere of Soviet or Chinese influence as pawns. This strategic choice predetermined their conscious intention to seek support of the US, transforming their states into *de facto vassal, or semi-sovereign, states*. It did not mean that the latter were *fully* dependent in a political sense (with the exception of Hong Kong that had been a British colony until July 1, 1997). They were broadly autonomous in their domestic affairs but supported the West politically in exchange for protection of the Anglo-Saxon powers (Castells 1998: 277; Woo-Cumings 1999: 21). In addition, there was also a whole complement of painful problems, such as an economic backwardness, a population mired in poverty and, therefore, a threat of the internal social unrest, which were incompatible with effective resistance to the Soviet and/or Chinese intrusion. In these complicated and unfavourable conditions, the successful modernisation looked as the only way for the small countries of East Asia to prevent the tragic outcome of events.

At the same time, the US and Japan were interested, mostly in the context of Cold War, to create a display case for ‘good capitalism’ in the region, intending thereby to neutralise the Soviet or Chinese influence (Cumings 1987: 59-66, 76-79; Hersh 1993: 44-50; Hersh 1998: 26-30, 33-36; Rostow 1986: 199; Shenin 2005: 37-46). In its turn, the West focused on resolving the proper economic problems that had arisen in the 1960s. Indeed, since the mid-1960s in the US (and three-four years later in Western Europe), the general effectiveness of capital, in particular, the rate of profits, had attained its peak and began to diminish (Castells 1980: 3-13, 78 et ff.). Moreover, the western societies underwent such new phenomenon as *the crisis of labour*, whose one aspect consisted of protest against the alienating character of labour at assembly lines when people with the complete secondary

8) As Manuel Castells noted, the main goal of the region’s catching up development was elementary *survival* (Castells 1998: 267).

school education demanded not only good wages but also expansion of opportunities for self-fulfilment (Gyllenhammar 1977: 9-10). Another aspect concerned the welfare state. In conditions where payments from the welfare state funds grew faster than increases in salaries and wages, significance of the latter declined, and leisure became often more advantageous than working (Carton 1984: 19-25).

A relocation of the least effective but labour-intensive branches of manufacturing industries from developed to peripheral and semi-peripheral countries appeared to be one of the ways to resolving the said problems.⁹⁾ Later, in the late-1970s and 1980s, this is closely correlated with *the social revenge* of neoconservatives who tended to erode the strong trade-unions and mass base of social-democracy at home, in the First World.

Resolving the internal as well as the global economic and political problems, the western countries, mainly the United States, lent assistance to their more favoured Asian allies, selectively opening the domestic markets to manufactured goods from East Asia. This measure was as essential for the success of the first-tier NICs as it was previously to Japan and later to the second-tier "tigers".

Apparently, the share of exports to the developed market economies in the total exports from the East Asian NICs was almost the same as from Latin America. For example, in 1970, when East Asian exports to the West began expanding, the share reached 70-80 per cent (73.8 % in the case of Latin America as a whole). The imports of Latin America and East Asia from the developed world were comparable to each other as well, fluctuating around 60-75 percent. However, the general ratio of exports to GDP was much higher in East Asia than in Latin America (table 1).¹⁰⁾

9) There is a broad complement of literature devoted to the problem of manufacturing industries' relocation from the centre to the Third World countries. Amongst many publications on this issue, the works by F. Fröbel and his colleagues have to be mentioned as pioneering studies on the given subject (Fröbel et al. 1980; Fröbel 1982: 539-551).

10) Except the small countries of Central America or Bolivia and Paraguay in the South (UNCTAD 1993: tables 3.4, 3.5).

Table 1. The ratio of total exports of goods and services to GDP in Latin American and East/Southeast Asian countries, 1960-1995

(%)

Countries	The ratio of exports to GDP:									
	in US dollars at current market prices					as adjusted to GDP in 1990 dollars by PPP				
	1960	1970	1980	1990	1995	1960	1970	1980	1990	1995
Argentina	8.5	7.1	3.9	8.7	8.2	4.4	3.3	5.4	5.8	6.5
Brazil	6.2	6.0	8.5	6.7	6.6	3.6	3.0	5.0	4.2	4.7
Chile	12.2	15.4	17.1	27.6	24.6	7.0	8.1	11.7	10.0	11.4
Colombia	10.9	10.3	11.9	17.6	11.4	5.5	3.6	5.6	4.5	4.7
Costa Rica	16.1	23.5	20.7	23.7	30.1	2.4	3.5	14.0	9.4	17.1
Mexico	6.1	2.3	9.3	15.5	27.8	2.9	2.0	6.6	7.9	12.4
Peru	21.1	16.8	19.0	9.2	10.4	6.7	6.7	8.5	5.1	5.6
Uruguay	10.5	9.5	10.5	18.2	11.1	4.9	5.1	8.7	8.4	7.9
Venezuela	31.1	22.9	32.6	36.3	24.7	15.4	7.4	20.3	11.0	8.6
Hong Kong	n.a.	97.1	71.1 ^{a)}	108.6	124.6	n. a.	77.8	56.3 ^{a)}	82.3	116.6
Korea, Rep. of	3.4	15.8	30.1	25.7	25.6	0.5	2.1	17.6	17.4	20.3
Singapore	n.a.	81.4	176.4	143.9	142.2	n.a.	54.1	140.0	121.7	153.6
Taiwan, province of China	11.6	29.5	46.8 ^{a)}	42.0	42.1	5.2	12.4	29.7 ^{a)}	33.5	34.8
Indonesia	n.a.	12.8	30.2	22.4	22.5	n. a.	2.7	12.5	5.7	6.1
Malaysia	65.3	46.1	54.4	66.8	83.0	45.7	26.0	40.7	32.8	46.9
Philippines	10.0	19.1	16.3	18.5	23.5	7.1	6.5	7.6	5.7	9.5
Thailand	18.0	16.7	19.4	27.0	34.1	7.1	5.6	8.6	9.0	12.8

Note: a) 1981

Source: author's calculations on: CEPAL/ECLAC 2001: 194-195, 528-529; IMF 1979, respective country tables; ADB 2000, respective country tables; Maddison 2003: 134, 137, 174-175.

Therefore, the external dependency of the Asian countries under consideration was strengthening while they conquered expanding niches in the Western (mainly American) and Japanese markets. This specific dependency encompassed originally

the first-tier "tigers" (Pempel 1999: 175-178) but rapidly spread to the second-tier ones, particularly, to Malaysia. It was notable, by the way, that in the case of East/Southeast Asia, *the state* played a more important role in the rise of this dependency than it did in Latin America. While a part of the bourgeoisie in the most developed countries of Latin America had some experience of entrepreneurship in industrial branches, private entrepreneurs in East and, particularly, Southeast Asia were economically weak and numerically small.¹¹⁾ It could not become the autonomous actor of modernisation, having only experience of entrepreneurship at a level that did not correspond to new tasks. Hence, in the specific conditions of Southeast Asia, the state had to become the main agent of development. In other words, the state should have been *the developmental state*, the characteristic feature of which was a partnership of the state bureaucracy and private business (Johnson 1982: 10, 17, 51, 70 ff.; Johnson 1987: 136-164; Woo-Cumings 1999) under the leading role of the former. *The state* steered private interests in accordance with the purposes of catch-up development, stimulating the accumulation of capital in manufacturing branches. Sometimes, it used administrative levers to enforce entrepreneurs to invest in certain industries according to chosen development priorities. In the course of such state activity, the specific group of bureaucracy, *the economic bureaucracy*, emerged in East Asia (Wade 1990: 195-227). This group has been the main (though not the only) social actor who dealt with the foreign MNCs. Thereby, it accomplished the function of "intermediary" between the internal and external structures/processes. In other words, it was mainly the economic bureaucracy, particularly in Malaysia and Thailand, that personified the associated-dependent development model in the region. It realised the strategic political decisions aimed at accelerated industrialisation, on the one hand, and provided conditions favourable to MNCs, on the other. In this respect, the economic bureaucracy exceeded its Brazilian and

11) The class of entrepreneurs in Southeast Asian countries (herein in Malaysia, Indonesia and Thailand but not in Singapore) was mainly performed by the local Chinese communities which made up the ethnic minorities in each of these countries.

Mexican counterparts (Cardoso, Faletto 1970: 123-129; Cardoso, Faletto 1978: 143-148; Schneider 1999) by degree of its involvement in the economy, dominating all other economic agents except, perhaps, the most influential and biggest MNCs.

Due to efforts of the developmental state, the rate of investment in GDP of the Asian industrialising countries, including the second-tier NICs, reached 35-40 per cent and sometimes even exceeded this level. The lion's share of this amount came from internal sources (savings). The foreign capital, very active in Malaysia and Thailand, performed modestly from the point of view of its share in the total domestic investments; but was crucial for transfer of new technologies and managerial achievements.

The high rate of investment meant the input-resources growth, which was mostly extensive (Ezaki 1998: 32-33; Pack 2001: 95-142; Sarel 1997; World Bank 1993: 46-69), could hardly be another at the stage of industrial take-off. None of the countries receiving focus in our analysis originally had the requisite entrepreneurial experience, sufficient volume of capital and skilled labour that were indispensable for intensive growth. It was necessary to make up for the lack of required qualitative resources and skills by an increasing amount of investment.

As in the case of Latin America, the fast economic growth of second-tier NICs impacted on the internal processes that were evolving hand-in-hand with the successful outward-looking industrialisation. In particular, it was accompanied by division of economy into the two parallel sectors feebly connected with each other; it succeeded in the rise of social-economic and social-cultural heterogeneity. The outward-looking sector was powerful and attracted the most part of foreign investments. It operated under the protection of the developmental state, adopted advanced technologies and attracted huge amount of assets, becoming the main engine of growth. On the contrary, the inward-looking sector had been like *a poor nephew of a rich uncle*. It encompassed mostly small and medium-sized enterprises that had neither access to banking loans with low rate of interest nor capability to hire qualified specialists. Often, these firms were subordinated through subcontracts to big, export-oriented companies, and the greater part of their profits

had been squeezed for benefits of "rich uncle". It did not abolish the old, "classical" dualism of traditional agrarian society and modern enclaves but essentially modified it. The latter appropriated new features while industrialisation progressed and the modern, urban sector expanded. In either of the second-tier NICs these processes evolved in their own way but, in essence, did not differ from those described by the associated-dependent development concept with respect to Brazil and Mexico (Bornschnier and Chase-Dunn 1985: 23-32, 117-147; Cardoso 1973: 157).¹²⁾

Certainly, Malaysia, Thailand, and Indonesia achieved a remarkable progress in poverty reduction during their years of accelerated industrialisation. For example, the share of the poor in Malaysia shrank from 50 per cent of the total population in the early 1970s to 6.8 per cent in 1997 when the financial-economic crisis put an end to the Malaysian boom (MoF 2000: lxi). The poverty eradication in Thailand and Indonesia was less visible but, by the world measure, undeniable. However, progress there did not eliminate the internal social-economic disparities, in particular, the interregional inequalities in all these countries. For example, in Thailand, the gap between the richest territorial-administrative entity (as a rule, the city of Bangkok or one of its vicinities) and the poorest province by gross provincial product per capita (at current prices) was 10.0 times in 1985. It widened to 15.2 times in 1990 with subsequent drop to 13.4 times on the eve of the Asian crisis, in 1996 (In 1999, i.e. after the crisis, the disparities between the richest and poorest provinces reached 13.8 times by gross provincial product per capita at current prices).¹³⁾ The household incomes in urban areas of Malaysia increased annually by 4.4 per cent from 1989 to 1995 whereas the incomes of rural households grew only by 1.5 per cent per year over the same period (Yusof 2001: 88, 91). Such inconsistencies impeded the internal market enlargement and impacted the

12) The growth of contemporary industrial, urban sector of the economy "contributes to social marginality and the underutilization and exploitation of manpower resources" (Cardoso 1973: 149).

13) Author's calculations on: NSO of Thailand 1994: 312-313; NSO of Thailand 1997: 280-281; NSO of Thailand 2004: 337-338.

general level of wages, inadvertently delaying the skill upgrades of labour force as a whole. Originally, the low level of wages was one of the Asian NICs' comparative advantages. But while their production technologies, mostly borrowed from abroad, progressed, insufficient labour skills became an obstacle comparable to lack of development of their own scientific-technological base and afflicted the "tigers" competitiveness in the long-term perspective. Soon or later, a slowdown of their export expansion, particularly, when they confronted competition with the Chinese, Vietnamese, and Indian firms, had to become inevitable. Actually, they had been facing such a slowdown already in the mid-1990s (UNCTAD 1996: 89, 102, 123). The outward-looking sector of the NICs' economies tended to maintain its expansion by augmenting the output of its main goods: electronic devices, their elements and concomitant parts. It required increased investment, including use of loans, but led to over-supply, on the one hand, and to growth of the short-term debt, on the other. In essence, the "tigers" were facing the problem of over-production of their exportable goods (Bagchi 2002: 212-215; Chin Kok Fay and Nordhaug 2002: 88-92, 94-97; Clairmont 2006; Nordhaug 2002: 11-13; Wade 1998: 361-364). This problem emerged together with increasing private borrowings in the conditions of premature liberalisation of the banking and financial sector.

In addition, a widespread illusion of persistent success allowed for an increase of imports of luxurious goods (this phenomenon rose in the 1990s): it represented 'relaxation' for the nouveaux-riches [This is French word; in French language: singular – nouveau-riche, plural – nouveaux-riches] after many years of forced frugality and obligatory savings.¹⁴⁾ The huge increases in demand for loans, together with the abnormal investments in construction and tremendously swollen realty market heated the financial bubble which hurtled inevitably toward a bursting point. On July 2, 1997, the bubble exploded in Thailand. The Asian crisis had begun, spreading to other members of the "tigers" family. The Southeast Asian

14) In 1995, Thailand has occupied the third position in the world in purchases of new 'Mercedes' cars (Lauridsen 1998: 161, note 22).

“new comers” of the industrial world did not yet completed their process of learning amidst imitative, catching up development; changing reality made it clear that their model for copying was inconsistent. In this respect, the “tigers” remained keeping the “empty box” in paws, as it had occurred in Latin American countries one decade earlier.

5. The Post-Crisis Development (1998 and onwards): Did the “Tigers” Make Right Conclusions?

Considering the post-crisis development of the second-tier “tigers”, it is necessary to take into account that, at first, this process signifies the aftermaths of the 1997-98 crisis. That crisis was not the ordinary economic meltdown but marked a definite frontier within the East-Southeast Asian development story. Secondly, it looks as indispensable to subdivide the post 1997-98 events into the two sub-periods: a) the post-crisis development from 1998 to 2008 when the new crisis began; b) the post-crisis development since 2009 and onwards. Meanwhile, in the author’s opinion, the last crisis did not resolve the old problems, or, at best, resolved only some of them and only partially. It is the main circumstance that allows us to scrutinise the two periods as a single process, recognising specific features of either of them.

Dealing with the post-crisis development of the Southeast Asian NICs, it is necessary to distinguish *the cause* of the 1997-98 crisis and its *concrete mechanism* from each other. The mechanism is studied and described very well in many publications. Unfortunately, it is difficult to say the same about *the cause*. The over-production has been only one, superficial aspect of the event. *The cause* as a whole consisted in the historical limit of catch-up development the East Asian NICs of both tiers reached based on accelerated, artificially-driven industrialisation by the mid-1990s (Inozemtsev 2001: 241-245, 298-299; Krasilshchikov 2008:

258-270). The NICs' economies as well as their political institutions could not adjust to the new global conditions when intangibles, such as human skills, knowledge, technological innovations and capabilities to elaborate them became more important for success than material elements of capital. Meanwhile, this *cause* was originally hidden behind a set of factors that came together to cause turbulence, though each factor individually could hardly lead the region to the serious trouble it underwent in 1997-98.

Did the elites in Southeast Asia grasp what happened to their countries by the end of the past century? Did they recognise the significance of education, scientific research, and human creativity for developments in the new era? Could the leaders of the countries in focus of our scrutiny drive their economic machines in the other direction, steering them towards a knowledge- and creativity-based society? At last (but not least), were there the real, "terrestrial" premises for changes of the development model, particularly, in the second-tier NICs, Malaysia and Thailand (Indonesia has been the more complicate case)?

Yes, they did, and, moreover, actually attempted to undertake some necessary steps in right direction but in theory rather than in practice and very lately, when they had to work at extinguishing the fire of crisis instead of preventing it. The cause of such delay was objective and did not depend on whosoever's political will or intellectual capabilities. The main obstacle to necessary changes in the Malaysian and Thai economies was not erroneous vision of reality by the ruling circles but successful development itself, which stoked euphoria and belief in the perpetuity of the "miracle". Such attitude, founded, by the way, upon the concrete interests, did not allow for modification of the chosen model of industrialisation (not including some several reforms *within* this model). Many people on both ends of social spectrum were interested in its continuation and had no incentive to change it. Thus, an apparent lack of interest to reform was, in essence, another form of 'interest' that consisted in maintaining linkage between local economies to external markets. However, a pursuit for immediate gain – at the expense of strategic advantage – led the second-tier "tigers" to "a middle-income trap", as the Malaysian

Table 2. The rate of GDP growth in the Southeast Asian NICs, the Philippines, China, and India, 1998-2010, percent relative to the preceding year.

Country	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Indonesia	-13.1	0.8	4.9	3.6	4.5	4.8	5.0	5.7	5.5	6.3	6.0	4.6	6.2	6.5
Malaysia	-7.4	6.1	8.9	0.5	5.4	5.8	6.8	5.3	5.6	6.3	4.8	-1.5	7.2	5.1
Thailand	-10.5	4.4	4.5	3.4	6.2	7.2	6.3	4.2	4.9	5.4	1.6	-1.1	7.5	0.1
Philippines	-0.6	3.4	4.4	2.9	3.6	5.0	6.7	4.8	5.2	6.6	4.2	1.1	7.6	3.9
China	7.8	7.6	8.4	8.3	9.1	10.0	10.1	11.3	12.7	14.2	9.6	9.2	10.4	9.2
India	6.7	6.4	4.4	5.8	3.8	8.5	7.5	9.5	9.6	9.3	6.7	8.4	8.4	6.5

Source: ADB 2009: 183 (data for 1998-99); ADB 2012: 175.

government announced in 2009 (Gomez 2012: 63). This situation is the particular case of much broader phenomenon that has to be called the *modernisation trap* – *the situation when achievements of catch-up industrialisation in the past, as well as sociopolitical institutions, principles of management and approaches to governance as a whole which enabled to attain success; became obstacles to further development in the new conditions.*¹⁵⁾ In essence, it has been the same situation as observed in Latin American countries where the inertia of import substitution industrialisation, despite some re-orientation towards exports under the authoritarian regime in Brazil, still impeded the *transformación productiva* in the 1970s. One of the clearest examples of the modernisation trap situation, already in the aftermath of the 1997-98 crisis in Asia, has been the attempt to upgrade the auto industry in Malaysia when the state intervention to promote this branch of economy was motivated by falsely conceptions and overconfident expectations of attainment for success, has turned as failure (Yusuf and Nabeshima 2009: 109-133).

15) "Policies and institutions that initially worked well in promoting growth and created social tensions have become counterproductive. The established political system faces demands to become more open, transparent, competitive and inclusive, but vested interests, ingrained behaviour and deeply rooted attitudes and incentives built into both public institutions and private business are impeding the necessary changes." (Nelson 2012: 44).

Table 3. The ratio of exports to GDP in Southeast Asian countries (per cents), 2002-2010 a)

Countries	The ratio of exports to GDP									
	in US dollars at current market prices					as adjusted to GDP in US dollars at PPP (for respective years)				
	2002	2004	2006	2008	2010	2002	2004	2006	2008	2010
Indonesia	32.7	32.2	31.0	29.8	24.6	10.6	11.1	13.1	15.0	15.3
Malaysia	108.3	115.4	112.2	99.5	93.7	40.0	45.7	48.8	51.3	55.4
Philippines	46.7	48.6	46.6	36.9	34.8	16.9	16.4	16.8	14.7	15.5
Thailand	60.8	66.1	69.0	71.7	66.7	20.0	23.4	27.0	31.5	33.2

Note: a) as the total sum of exported goods and services

Source: ADB 2011: 161, 170 and respective country tables, author's calculations on the same source.

Remembering, however, that this case reflected only one aspect of the general problem, the post-crisis development as a whole in the region should be assessed from the point of view of its adequacy to the task to getting out of the modernisation trap in a broad sense, not stressing exclusively on financial, managerial or governance issues.

Apparently, the “tigers” recuperated their health after the crisis of 1997-98 very quickly. Their economic growth resumed already by the end of 1998, although it did not reach the average rate of the pre-crisis decade (and some “tigers” even experienced a recession in 2001) and did not exceed the pace of growth in China and India (see table 2).

At the same time, the region's dependence on the external markets continued to be (for comparison with the analogous data for the mid-1990s see above table 1), as table 3 shows.

At the same time, the geographical directions of the observable countries' external trade changed notably since the end of the 1990s. At first, the external

Table 4. Changes of the exports structure of the Southeast Asian NICs, by direction of trade, as per centage of the total exports, 1985-2010

Indonesia							
Main trade partners	1985	1990	1995	2000	2005	2007	2010
United States	21.73	13.10	13.92	13,66	13.24	12.67	11.52
Japan	46.21	42.54	27.05	23,20	21.07	20.32	19.41
China, PR	0.45	3.25	3.83	4,45	5.08	8.25	7.73
Singapore	8.74	7.41	8.29	10,56	9.36	8.11	11.85
Korea	3.53	5.31	6.42	6,95	7.19	6.53	7.87
Malaysia							
Main trade partners	1985	1990	1995	2000	2005	2007	2010
United States	12.79	16.95	20.77	20,54	19,69	15,62	10,47
Japan	24.56	15.32	12.48	13,02	9,35	9,13	8,93
China, PR	1.04	2.10	2.56	3,09	6,60	8,77	19,81
Singapore	19.41	22.95	20.29	18,39	15,61	14,63	14,30
Hong Kong	1.34	3.17	5.35	4,52	5,85	4,62	4,29
Netherlands	5.83	2.63	2.42	4,19	3,27	3,90	3,24
Thailand							
Main trade partners	1985	1990	1995	2000	2005	2007	2010
United States	19.68	22.71	17.62	21,32	15,39	12,63	10,36
Japan	13.35	17.20	16.57	14,74	13,60	11,89	10,45
China, PR	3.80	1.17	2.87	4,07	8,27	9,73	10,99
Hong Kong	4.04	4.50	5.11	5,04	5,56	5,70	6,72
Malaysia	4.98	2.49	2.72	4,08	5,25	5,11	5,41
Singapore	7.95	7.35	13.84	8,70	6,94	6,25	4,62

Source: author's calculations on ADB 2004, ADB 2005, ADB 2011, respective country tables.

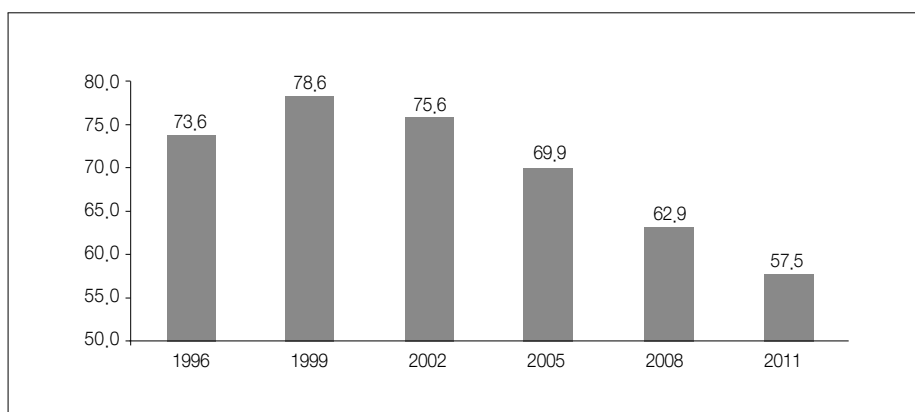
trade of the Southeast Asian NICs (including the Philippines as “under-tiger”) becomes the intraregional trade in ever-extending degree. Their previous dependence on the western markets has steadily been declining whereas the dependence on neighbours, mainly on China, has increased. Table 4 illustrates it very clearly.

Secondly, the post-crisis development (more exactly, the post-crisis development-1) of the Southeast Asian countries has been characterized by their intensifying competition with China, particularly, in sectors which were the most important in the course of their “miracle” – manufacturing of electronic devices. Simultaneously, the structure of the second-tier NICs’ exports began worsening while the volume of their trade with China increased. The share of primary goods (raw materials and agricultural products), which decreased in terms of exports until the first (1997-98) crisis, had begun to grow again whereas the share of manufactured goods, respectively, diminished. For example, the share of primary and manufactured goods of low technologies in exports of Indonesia has increased from 67.7 per cent in 2000 to 71.9 – in 2007; respectively, the share of machinery, electric/electronic equipment and instruments, which had grown from 1.8 per cent in 1990 to 18.4 per cent in 2000, decreased by 4 per cent points to 2007. The worsening of the export structure in the case of Malaysia (more developed country than Indonesia!) has been more severe than that of Indonesia. The share of primary and low-technology manufactured goods, which shrank from 53.4 per cent in 1990 to 25.8 per cent in 2000, has increased to 34.6 per cent on the eve of the last crisis (2007). Respectively, the share of electrical/electronic devices and equipment in the Malaysian exports has dropped from 64.5 per cent in 2000 to 51.9 – in 2007.¹⁶⁾

The crisis of 2008-09 did not alter the trend that has been observed since the late-1990s, after the preceding crisis – the rising share of primary and

16) Author’s calculations on: ADB 2004, ADB 2006, ADB 2008, respective country tables.

Figure 2. The share of manufactured goods in the exports of Malaysia, 1996-2011
(as percentage of the total exports)



Source: the author's calculations on MoF 2001, table 3.6; MoF 2006, table 3.6; MoF 2012, table 3.1.

low-technology manufactured goods in the exports of Malaysia, Thailand, and Indonesia. On the other hand, the share of more technologically complicated manufactured goods in their exports began to decline. In particular, the share of machinery and transport equipment in Malaysian exports declined from 49.0 per cent in 2007 to 43.9 per cent in 2010 with subsequent decrease to 38.8 per cent in 2011.¹⁷⁾ The worsening structure of the country's external trade as a whole is shown on diagram 2.

Such dynamics of the exports allows researchers to presuppose that the second-tier "tigers" including Malaysia (the most advanced), began drifting gradually back to the world periphery, becoming, to an extended degree, suppliers of commodities instead of manufactured goods. This descending development trend has been progressing together with the slowdown of foreign direct investment (FDI). The latter in absolute terms has reached 8.6 billion dollars in 2007 (before the crisis), fallen to 1.43 billion in 2009 and increased nearly to 12.0 billion in

17) Author's calculations on: MoF 2011, table 3.1; MoF 2012, table 3.1.

Table 5. The share of the Southeast Asian countries, China and India in the total world FDI inflows, 1985-2010 (as per centage).

Country \ Year	Average over 1985-1990	1995	2000	2005	2010	Average over 2006-2010	2011
Indonesia	0.39	1.37	- 0.33 ^{b)}	0.85	1.07	0.54	1.24
Malaysia	0.74	1.31	0.27	0.41	0.73	0.42	0.78
Philippines	0.29	0.47	0.10	0.19	0.14	0.15	0.08
Thailand	0.72	0.63	0.24	0.82	0.47	0.52	0.63
Viet Nam	0.02	0.63	0.09	0.21	0.66	0.45	0.49
Southeast Asia as a whole (10 countries) ^{a)}	4.26	6.71	1.34	4.15	6.38	4.00	7.65

Notes: a) Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam.

b) “-” means outflow of previously made investment.

Source: see footnote 17.

2011. However, it is almost the same share of Malaysia's total FDI inflows in the world in average in 1985-90. The highest level of this indicator attained by Malaysia over the whole period of industrial boom is apparently back – 1.31 % in 1995 and 1997, 1.52 % – in 1996.¹⁸⁾ The similar tendency has been observed, too, in other second-tier “tigers”. They all lost competition in terms of attracting FDI to China and India as well as to their rising neighbours in ASEAN, Vietnam (see table 5).

It is worth noting that the FDI inflows into Malaysia have been directed mostly to the technologically complicated branches of industry (electronics, etc.) (Hew 2006: 262) whereas other branches, less developed in technological respect, are not attractive for them. It aggravates an unevenness of development (as the associated-dependent development conception predicted!) in interbranch as well as interregional aspects, and afflicts, inevitably, the country's labour market. The

18) Sources and author's calculations on: UNCTAD 1997: 303, 306; UNCTAD 2003: 249, 251; UNCTAD 2011: 187, 189.; UNCTAD 2012: 169-170.

latter as a whole did not return to the previous conditions even at more than ten years after the first, 1997-98, crisis. While the rate of unemployment in Malaysia was only 2.5 percent in 1996, it increased to 3.4 percent in 1999 and fluctuated between 3.1 – 3.7 percent in 2001-2012. The respective indicators in Indonesia were worse a a short time before the crisis of 1997-98 (4.7 percent in 1997) but apparently increased over the first decade of this century: the rate of unemployment on the eve of the last crisis was 8.4 percent and declined to 7.1 in 2010 with further decreases to 6.6 percent in 2011. Thailand looked much better after the meltdown of 1997-98 (4.4 percent in 1998) and reduced the rate of unemployment to 1.0 and 0.7 per cent in 2010 and 2011, respectively (ADB 2012: 142 and respective country tables). Nonetheless, many people in Indonesia and Thailand previously held jobs at manufacturing plants but were forced to go back to rural areas or to seek jobs in the large informal sector. This sector in Thailand absorbed 58.0 per cent of the urban employment in 1994 and 59.9 per cent – by 1999 (ADB 2005: 18; Amin 2002: 17). In total, 22-23 million people were employed in the country's informal sector by 2005-06. Its number had grown to 24 million over the next two years, almost equal to the rate of employment – 58.3 % (UNDP 2007: 8; UNDP 2009: xiii, 10-11).

The crisis of 1997-98 stopped the trend toward poverty reduction, though not drastically. In Malaysia, the share of the poor increased from 6.1 per cent of the population in 1997 to 7.5 percent in 1999 (Ragayah 2012: 236). The share of people living beyond the national poverty line in Thailand increased from 11.4 per cent in 1996 to 15.9 per cent by 1999 (Deolalikar 2002: 4). However, by the international criteria, the country's reality was far from idyllic. In 2000, over two years after the crisis, there were 1,204.5 thousand people whose daily income did not exceed 1\$ by PPP (the absolute poverty line!) and 20,264.5 thousand who earned only 2\$ a day (1.9 and 32.5 per cent of the population, respectively) (ADB 2004: 26). The situation in Indonesia appeared as much worse than in the two mentioned countries. The share of population below the national poverty line in the country rose from 11.3 per cent in 1996 to 18.2 per cent in 1999 and did

not change over the next years, the resumed economic growth notwithstanding. In 2003, 50.5 per cent of all people in Indonesia survived below the international poverty line, or \$2 a day (70.9 per cent – in 1990, before the pre-crisis boom); the number of poor was slowly but steadily declining over the post-crisis decade, until the advent of the next crisis (2008-09) (ADB 2005: 116; ADB 2006: 96; UNESCAP 2004: 246-247). In 2010, after the second crisis, the share of the poor who lived for \$2 at PPP per day has dropped in Indonesia to 46.1 per cent (ADB 2012: 147). It may appear serious but still represents progress compared to the situation in 1998-99. Nevertheless, the prospects of poverty reduction in the country look unclear because the national welfare state, like in other Southeast Asian countries, is still in its infancy, and the social security system encompasses only minority of the workers and employees, occupied mostly in the public and formal private sectors.

The poverty reducing slowdown is undistinguishable from interruptions in the decrease social-economic inequality, a noticeable feature of the regional conditions. The deepest inequality among the second-tier “tigers” under consideration has been in Malaysia where the poverty rate (2.3 per cent of population) (ADB 2012: 147) is consistently lower than in Indonesia or Thailand.¹⁹⁾ This apparent paradox is related to the nature of development in Malaysia where a penetration of foreign capital in manufacturing industries and, simultaneously, the state regulation of market has originally been more profound than in neighbouring countries (except Singapore). Since the technologically advanced outward-looking high-tech sectors of the economy evolve with greater correspondence to global demand than to the domestic needs, the export-driven growth would inevitably lead to widening inequalities (Gill and Kharas 2007: 275 et ff.) if the state did not counter this process with social policy.²⁰⁾ These inequalities encompass not only income

19) It is a fact that Gini coefficient in Malaysia is higher than in other Southeast Asian NICs, as can be seen in the poverty and inequality regional tables in each issue of “Key Indicators...” that have been published every year by the Asian Development Bank.

20) The economic development after the crisis of 1997-98 perpetuated a “disconnect” between

Table 6. The productivity in Malaysian economy, 1995-2010, by sector (measured as output value per employed person in ringgits at constant prices of 2000)^{a)}

Branches \ Year	1995	1998	2001	2004	2007	2010
Agriculture, forestry and fishing	19606,5	20939,6	22554,0	24943,9	27503,2	29429,6
Manufacturing industries	38099,9	38222,9	42351,2	42789,0	46042,7	45728,5
Construction	17672,3	15486,5	15750,5	18670,8	20245,6	23801,4
Transport, storage and communication	53212,5	58418,1	63003,8	52116,8	57783,3	65765,3
Finance, insurance, real estate	79293,9	94176,9	87160,6	89757,8	1021534,0	114612,2
Government services	23212,3	25954,9	26181,6	27224,8	29795,7	33598,2
Other services ^{b)}	36072,6	36690,8	36419,5	31781,4	41405,4	45544,0
Average	38167,1	41412,8	41917,3	41040,6	46418,6	51211,3
Coefficient of variation	0,577	0,657	0,603	0,591	0,595	0,609

Notes: a) Without mining and quarrying

b) Including electricity, gas and water supply, wholesale and retail trade, hotels, and restaurants

Source: author's calculations on MoF 2000, 2004, 2007: tables 2.2, 6.1; MoF 2009, table 2.3; MoF 2011: tables 2.3, 6.1.

distribution but also productivity growth in different sectors of the economy, and these inequalities are, in essence, more essential with respect to future prospects than any income disparities. The following table (table 6) illustrates an unevenness of this growth in Malaysia from the point of view of the main economic branches' dynamics.

The coefficient of statistical variation demonstrates in the given case what the inter-sector disparities are from the point of view of the sectors' productivity. Its jump from 0.577 in 1995 to 0.657 in 1998 characterises a degree of turbulence the country's economy experienced during the crisis of 1997-98. After the latter, the economic situation began stabilising but since the middle part of the past decade

the outward- and inward-looking sectors of the country's economy (Hew D. 2006: 263-264).

the inter-sector disparities began widening again and did not return to the level of 1995, the period of Malaysian prosperity. Such unevenness impacts on the character of inequality, which runs through the entire society, while old, non-economic factors of inequality become less significant. In particular, the inequality *within* rural and urban areas or *within* the main ethnic groups (Malays, Chinese, and Indians) currently exceeds the inequality *between* rural and urban areas as well as *between* different ethnic groups (Ragayah 2012: 242-244, 252). In other words, the recent inequality in Malaysia is of a “purely” socioeconomic nature, albeit to an extended degree. As the authors of the National Economic Advisory Council’s report recognised in 2010, the gap between the rich and poor in Malaysia is excessively wide, in spite of the visible decrease of poverty (from 6.1 per cent of the population in 1997 to 3.6 per cent – in 2007). The Gini coefficient dropped from 0.459 in 1997 to 0.441 in 2007 (before the last crisis) only due to poverty and inequality reduction in rural areas (from 0.441 to 0.388, respectively), whereas it did not change in urban areas at all (0.427 in the both mentioned years) (NEAC 2010: 57-58; Ragayah 2012: 239-240). The report noted also that the yields of growth since 1990 were being distributed primarily to the advantage of the top 20 per cent of all households. The incomes of the bottom 40 per cent of families, mostly in the countryside, grew slowly. It meant that the growth in Malaysia had a mostly elitist character and excluded a big part of the population from development. “This less-than-satisfactory distribution of wealth prevents a large portion of Malaysians from sharing the fruits of progress. In the long run, this hampers social mobility, again inhibiting large numbers of Malaysians from fully realising and developing their potential to contribute to the economy” – the authors of the report wrote (NEAC 2010: 59).

The one-sided development, similar somewhat to that in Brazil under the authoritarian modernisation, affects a quality of labour force as a whole. Certainly, it is impossible to demolish the progress in human resources development attained over the years of Malaysian modernisation, but today it appears as insufficient in the conditions of a globalised economy. Moreover, some observers even note the backwardness of human capital and, hence, make conclusions about the

deficiency of skilled labour force in the country (Yusuf and Nabeshima 2009: 26, 28, 132-134), although Malaysia, obviously losing to Singapore, exceeds all other ASEAN countries, both "tigers" and "under-tigers", in this respect. It is worth noting that the relevance of Malaysia to a group of middle-income nations does not facilitate resolution of this problem but aggravates it. Malaysia is an attractive destination for migrants, including illegal ones, from the low-income countries, such as Indonesia, the Philippines or Bangladesh, but cannot provide well-paid prestigious jobs for its own skilled labourers and professionals who know English since childhood (a heritage of the British colonialism is a comparative advantage!) and have sufficient skills for good jobs in Singapore, Australia or the Great Britain (Jones 2012: 262, 265, 268, 273-274).

Certainly, the skilled labourers' deficiency is not the only factor that keeps Malaysia in a middle-income trap (modernisation trap, in a broader sense). There are also such obstacles to getting out of this trap as the vested interests of the UMNO (the ruling party) bureaucracy and government-linked corporations that have no desire to change the established system. However, the latter is suffering from slow pace of development amidst changing conditions (Nelson 2012: 51), and emerging economic difficulties – the growing public debt and budget deficit together with imperfections of the banking sector (Azrai and Zeufack 2011: 314-322) – is aggravating the recent deceleration of economic dynamics. Nevertheless, a shortage of the skilled labour force and weak technological capacities are the main factors that are interconnected with each other and impeding Malaysia from escaping the modernisation trap. They will continue operating as obstacles to attaining developed-country status, and unfortunately, is unlikely to surmount the problems in the near future.

6. Towards a Knowledge-Based Society?

The political leaders, top officials and businessmen in the region understand very well that it is impossible to resolve the problems of competitiveness, sustainable growth, and financial stability, without paying attention to the R&D system, education and quality of human resources.

Some positive changes among second-tier “tiger” economies began occurring in the aftermath of the 1997-98 crisis, which can be illustrated by the patenting data. Over ten years, from 1990-94 to 2000-04, the average number of patents granted annually by the United States Patent and Trademarks Office (USPTO) has increased 2.5 times in Indonesia, 5 times – in Malaysia, and 7 times – in Thailand. However, these numbers in absolute terms look insignificant being compared to those granted to their senior “brothers in tigerness” – Hong Kong, Korea, Singapore, and Taiwan province, without mention of the US and Japan (table 7).

Among the second-tier “tigers”, only Malaysia showed some accomplishments in science and technology after the 1997-98 meltdowns. The country elevated its total R&D expenditures from 0.22 per cent of GDP in 1996 to 0.39 per cent in 1998, then to 0.50 per cent in 2000 (a growth of 48 per cent over two years!!), and to 0.69 – in 2002. Two years later, in 2004, the amount of R&D expenditures had increased, too, in absolute terms but dropped as a per centage of GDP – to 0.63. It is notable, in addition, that the share of the country’s private sector in the total expenditures for R&D had grown from 57.9 % in 2000 to 65.3 % in 2002 and then to 71.5 % in 2004 (MASTIC 2000: II, IV, 10; MASTIC 2004: 7, 16, 43; MASTIC 2007: 6, 17). However, since the middle of the past decade, on the eve of the last crisis, the trend of positive growth came to a halt, and Malaysia not only began losing competition in science and technology (S&T) to first-tier NICs but also manifested a slowdown in the pace of S&T development with regard to her neighbours, Thailand and Indonesia. The share of research and development (R&D) expenditures in the Malaysian GDP has reached 0.64 per cent

Table 7. Patents Granted by USPTO (annual averages), 1990-94 and 2000-04

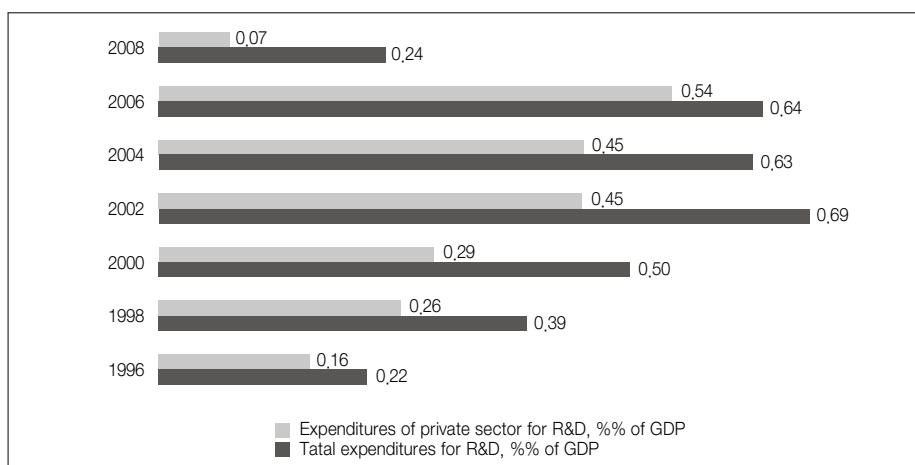
Country	Number of patents		Patents per 100,000 population	
	1990-94	2000-04	1990-94	2000-04
The first-tier NICs				
Hong Kong, China	184	616	3.15	9.32
Korea, Rep. of	633	4 009	1.44	8.67
Singapore	36	382	1.09	9.87
Taiwan, province	1 307	6 593	6.30	30.17
The second-tier NICs and the Philippines				
Indonesia	6	15	0	0.01
Malaysia	13	64	0.07	0.28
Philippines	6	18	0.01	0.02
Thailand	6	43	0.01	0.07
United States	59 024	97 104	23.00	33.56
Japan	22 647	35 687	18.23	28.54

Source: Gill and Kharas 2007: 155.

in 2006, what was much bigger than in the abovementioned two countries, but decreased afterward. It has dropped in absolute terms from 3.6 billion ringgits (RM) in 2006 to 1.7 billion in 2008 – 0.24 per cent of GDP (MASTIC 2010: 5-2). This drastic fall has been explained by the decline of private R&D expenditures; the private sector has cut them 6 times from 2006 to 2008 when the first signs of the coming crisis have appeared (MASTIC 2010: 5-3). The diagram 3 illustrates this clearly. In general, it approves that private firms in Malaysia cannot yet operate as autonomous agents capable of realizing the long-term strategy if a “visible hand” of the state does not push them.

Such indicators of S&T development as the number of researchers per 10,000 labour force and per 10,000 population in Malaysia also lag far behind the level of developed countries and the first-tier NICs. This number began increasing rapidly just after the preceding crisis but has stagnated in 2006-07 and remained virtually

Figure 3. The total and private expenditures for R & D in Malaysia as per centage of GDP, 1996-2008



Source: MASTIC 2000: II, IV, 10; MASTIC 2004: 7, 16, 43; MASTIC 2007: 6, 17; MASTIC 2010: 5-2, 5-3 and author's calculations.

unchanged until today. In 2000, it was 15.6 per 10,000 labour force (6.4 per 10,000 population) and while it rose to 21.3 per 10,000 labour force in 2004 (9.0 per 10,000 population) (MASTIC 2010: 3-3) it was still much lower than in Korea and Singapore. In Korea, there were 60 researchers and assistant personnel per 10,000 labour force in 1998 (with increase to 89.3 in 2003), in Singapore – 83.5 per 10,000 in 2000 and 111.3 – in 2003 (for comparison: 74 per 10,000 in the US (1999), 95/10000 in the UK (1995), and 131.5/10000 in Japan – (2003)) (MASTIC 2000: III, VII, 18; MASTIC 2004: 7; MASTIC 2007: 59). Ultimately, the number of researchers in Malaysia has reached 22.7 per 10,000 labour force in 2008 (9.2 per 10,000 population (MASTIC 2010: 3-4). Obviously, this amount is still not comparable with the respective indicators in developed countries.

In addition, expenditures for R&D and most researchers in Malaysia have mainly been concentrating in applied researches, whereas basic, fundamental ones are not given robust support. Such orientation of R&D towards solution of practical

tasks can be effective from the point of view of prompt commercial success but will hardly extricate the country from the scientific-technological dependency on the world leaders.

Deficiencies and difficulties of the S&T development in Malaysia, not to mention less successful Thailand and Indonesia, are clearly seen in the Multimedia Super Corridor (MSC) story. In 1996, the Malaysian Prime Minister Mahathir Mohamad launched construction of this supposed monument to his developmental policy. The project involved building a techno-park and green-field (52 km long, 15 km wide) that extends from the well-known skyscrapers Petronas Twin-Towers in the north to the new Kuala Lumpur International airport in the south. In the middle, two new cities were put up, Putrajaya and Cyberjaya. The former is now the new administrative capital, the latter is the centre for scientific research and Multimedia University.

As it was originally suggested, the programme for MSC development is to be realized gradually over twenty years, with completion approximately at 2020. The program is subdivided into three different phases. The first phase (1996-2003) involves attracting advanced world-class companies and elaborating the system of rules and laws that would regulate MSC activity. The principal goals that corresponded to this phase were obtained. Phase II (2004-2010) linked the MSC to other cyber-centres in Malaysia and abroad as well, thereby building a network of centres connected to the MSC. The last stage, phase III (2011-2020) is projected to spread the information technologies and communication (ITC) centres to all areas of the country, transforming Malaysia into a true knowledge-based society.

However, realisation of phases II and III has been much more difficult than it seemed at the planning stage. In particular, aside from a weak national scientific research base, diffusion of MSC "yields" faced the problem of insufficient demand for ITC in some parts of the country. By the mid-2011, there were 22 MSC cybercities and cybercentres operating nationwide (MoF 2011: 54), which can be regarded as evidence of relative success of the MSC project implementation. Nevertheless, some remote countryside areas, mainly, in Kalimantan (Sabah and

Sarawak states), remained out of the MSC network and could not become a home for the MSC products, as many villages did not even have electricity for some years (Singh Tyndall P. 2002: 191).²¹⁾ In essence, the attempt to transform Malaysia into a fully developed, knowledge-based society was confronted with the same problem as the elitist modernisation in Brazil in the past century under authoritarian military-bureaucratic regime.

The situation in R&D sectors of Thailand and Indonesia has apparently been worse than in Malaysia. Formally, the governments of these two countries also proclaimed the turn towards a knowledge-based society. For example, Indonesia launched the plan for “Creating a Nusantara Telematic Society by the Year 2020” with emphasis on information technologies, but has done little to realise this programme (Evers 2003: 357, 361-364, 371). Thailand elaborated a proper programme of scientific and technological development but the Thai national innovation system (including the National Science & Technology Agency, NSTDA) could not overcome poor strategic planning and coordination. As in the years of industrial boom, the country displayed a lack of interest to the results of R&D from local business. In contrast to widespread expectations, the Japanese, US, Korean and other firms, operating in Thailand, did not become engines of technological innovations. All these deficiencies and problems have been aggravated by ineffective bureaucratic structures that imitate a certain activity but fail to implement real technological and managerial improvements. Thus, the national scientific and technological base in Thailand has been left weak and vulnerable after the 1997-98 crisis as well as before the financial storm (Altenburg *et al.* 2004: 17-18, 21-27). The crisis of 2008-09 did not change the situation for the better, and uncertainties regarding the country’s future prospects continue as it did despite the economic growth.

21) It has to be noted that the problem of accessibility to electricity was almost resolved in Malaysia by the end of the past decade. Only such poor states as Sabah and Sarawak have had the rates of households’ electrification in rural areas 91.4 and 93.8 per cent of all countryside households, respectively (DoS 2012: 31).

The ruling circles and experts' community in Southeast Asia are certain that the main way to overcome their countries' backwardness in S&T and sustain growth in a globalizing environment lies in a sphere of the national education improvement. However, in recognising an importance of education, the Malaysian authorities, placed most of their emphasis on tertiary education in order to upgrade the skills of specialists in sciences and technologies (Lee Hock Guan 2006: 232). It did not mean that the primary and secondary levels of education were ignored at all but it was mostly the tertiary level where the state concentrated its main efforts, both public and private. In essence, the Malaysian government involuntarily repeated the strategic mistake of Brazilian authoritarian modernisers in the 1960s-80s; it was attentive to higher education but neglected the primary, lower secondary and, particularly, upper secondary education. It has shown the same technocratic attitude to education issues, corresponding to an elitist, hierarchical vision of development, as inherent among "miracle-makers" in Brazil forty years ago. It is not surprising that the problem of discrepancy between the economy's needs and the education system's "outcomes" became a visible agenda, and the experts consider it, with much anxiety, as a serious threat to the country's position in the world (Jones 2012: 272-273; NEAC 2010: 6). Evidently, it is impossible to resolve this problem in a few years apart from complete overhaul in equipment or building entire assembling plants. The old approaches and solutions that were appropriate at the stage of imitative, catch-up development are hardly relevant in the conditions when transition towards a knowledge-based society becomes the national goal and imperative for survival.

7. Conclusion

An assessment of Latin American industrialisation as "truncated development" with insignificant positive results (the "empty box") in contrast to East Asia's

“miraculous” modernisation was justified as globalisation intensified and the state-led import substitution industrialisation came up against its limits. The outward-looking economies of Asia, the first- as well as the second-tier “tigers” were performing as much more successfully and effectively than Latin American countries, which are beset with acute internal problems. However, the East and, particularly, Southeast Asian success story evolved, in essence, within the framework of the same associated-dependent development model which was inherent to Brazil and Mexico since the second half of the 1960s. This model, combined with internal and external factors of catch-up development, correlated with the economic processes in the developed countries of the west. It has also been characterised as uneven in results and contributing cause to widening inequalities, an incidence of the general level of poverty notwithstanding. Sooner rather than later, these inequalities and unevenness have come to impede further development as it did in Brazil under the military-bureaucratic authoritarianism in the 1970s-80s.

The second-tier NICs of Southeast Asia now find themselves in the modernisation trap (a particular case of which is “the middle-income country trap”). They had become victims of their own success that radically reduced extreme poverty but did not yet abolish the ‘internal peripheries.’ Getting out of this trap will be impossible until they merge fast growth with a change in the development model for more emphasis on education and scientific research and resolving proper social problems. Namely, they ought to work towards eradicating the internal periphery and propelling the process of inclusive growth before effort at transition towards a knowledge-based society. In this respect, the Brazilian experience of social-developmentalism (*social-desenvolvimentismo*) (Pochmann 2010: 117 et ff.) which means the general modernisation through resolution of the social problems, including bring more people previously excluded from development into the development process, can be very useful for the “tigers” if they do not want to remain keeping an “empty box”.

References

- Adams, F.G. and Ichimura S. eds. 1998. *East Asian Development: Will the East Asian Growth Miracle Survive?* Westport (Conn.), L.: Praeger.
- ADB (Asian Development Bank). 2000. *Key Indicators of Developing Asian and Pacific Countries 2000*. Hong Kong, Manila: Oxford University Press (China) with Asian Development Bank.
- _____. 2004. *Key Indicators of Developing Asian and Pacific Countries 2004: Poverty in Asia: Measurement, Estimates, and Prospects*. Manila: ADB.
- _____. 2005. *Key Indicators of Developing Asian and Pacific Countries 2005: Labor Markets in Asia: Promoting Full, Productive, and Decent Employment*. Mandaluyong City, Philippines: ADB.
- _____. 2006. *Key Indicators of Developing Asian and Pacific Countries 2006: Measuring Policy Effectiveness in Health and Education*. Mandaluyong City, Philippines: ADB.
- _____. 2008. *Key Indicators for Asia and the Pacific 2008*. Mandaluyong City, Philippines: ADB.
- _____. 2009. *Key Indicators for Asia and the Pacific 2009*. Mandaluyong City, Philippines: ADB.
- _____. 2011. *Key Indicators for Asia and the Pacific 2011*. Mandaluyong City, Philippines: ADB.
- _____. 2012. *Key Indicators for Asia and the Pacific 2012*. Mandaluyong City, Philippines: ADB.
- Altenburg, T. et. al. 2004. *Strengthening Knowledge-based Competitive Advantages in Thailand. (GDI Reports and Working Papers, 1/2004)*, Bonn: GDI/DEI.
- Amin, T. M. N. 2002. *The Informal Sector in Asia from the Decent Work Perspective. (ILO Working Paper on the Informal Economy No 4)*, Geneva: ILO.
- Azrai, E. M. and Zeufack, A. G. 2011. "Malaysia: Postcrisis Growth Prospects Depend on Restoring Fiscal Discipline and Private Investor Confidence."

- Mustapha K. Nabli ed. *The Great Recession and Developing Countries*, pp. 303-350.
- Bagchi, A. K. 2002. "Governance in East and Southeast Asia: What's New?" *The European Journal of Development Research*, 14 (1), pp. 200-218.
- Barlow, C. ed. 2001. *Modern Malaysia in the Global Economy: Political and Social Change into the 21-st Century*. Cheltenham (UK), Northampton (Ma, USA): Edward Elgar.
- Bornschnier, V. and Chase-Dunn, Ch. 1985. *Transnational Corporations and Underdevelopment*. N.Y.: Praeger.
- Cardoso, F. H. 1972. "Dependency and Development in Latin America." *New Left Review*, N 74, pp. 83-95.
- _____. 1973. "Associated-Dependent Development: Theoretical and Practical Implications." Stepan, A. ed. *Authoritarian Brazil*, pp. 142-176.
- _____. 1977. *O Modelo Político Brasileiro e Outros Ensaio*s, 3-ra ed. Rio de Janeiro, São Paulo: Difel.
- _____. 1979. "On the Characterization of Authoritarian Regimes in Latin America." D. Collier ed. *The New Authoritarianism in Latin America*, pp. 33-57.
- Cardoso, F. H. 2007. "Análise e memória (recordações de Enzo Faletto.)" *Tempo Social (revista de sociologia da USP)*, 19(1): pp. 215-221.
- Cardoso, F. H. y Faletto, E. 1970. *Dependencia y desarrollo en América Latina. Ensayo de interpretación sociológica* (1-ra edición – 1969). México: Siglo XXI.
- _____. 1978. *Dependency and Development in Latin America*. Translated by Marjory Mattingly Uriguidi, Berkeley, Los Angeles, L.: University of California Press.
- Carton, M. 1984. *L'éducation et le Monde de Travail*. Paris: UNESCO.
- _____. 1980. *The Economic Crisis and American Society*. Princeton (N.J.): Princeton University Press.

- Castells, M. 1998. *The Information Age: Economy, Society and Culture*, Vol. III. End of Millennium, Oxford (U.K.), Malden (Ma): Blackwell Publishers.
- CEPAL/ECLAC (Comisión Económica para América Latina y el Caribe/Economic Commission for Latin America and the Caribbean). 1993. *Anuario Estadístico de América Latina y el Caribe /Statistical Yearbook for Latin America and the Caribbean 1992*. Santiago de Chile: Naciones Unidas.
- _____. 2001. *Anuario estadístico de América Latina y el Caribe/Statistical Yearbook for Latin America and the Caribbean 2000*. Santiago de Chile: Naciones Unidas.
- CEPAL. 2008. *La transformación productiva con equidad 20 años después: Viejos problemas, nuevas oportunidades*. Santiago de Chile: Naciones Unidas.
- _____. 2012. *Cambio estructural para la igualdad: Una visión integrada del desarrollo*. Santiago de Chile: Naciones Unidas.
- Chia Siow Yue and Lim, J. J. eds. 2002. *Information Technology in Asia: New Development Paradigms*, Singapore: ISEAS.
- Chin Kok Fay and Nordhaug, K. 2002. "Why Are There Differences in the Resilience of Malaysia and Taiwan to Financial Crisis?" *The European Journal of Development Research*, 14(1), pp. 77-100.
- Cumings, B. 1987. "The Origins and Development of the Northeast Asian Political Economy: Industrial Sectors, Product Cycles, and Political Consequences." F. C. Deyo ed. *The Political Economy of the New Asian Industrialisation*, pp. 44-71.
- Clairmont, F. 2006. "East Asia: The Simmering Cauldron." H. Singer *et al.* eds. *Newly Industrializing Countries after Asian Crisis*, part V, pp. 1978-1982.
- Collier, D. ed. 1979. *The New Authoritarianism in Latin America*. Princeton (N. J.): Princeton University Press.
- Collier, D. 1979. "Overview of the Bureaucratic-Authoritarian Model." D. Collier ed. *The New Authoritarianism in Latin America*, pp. 19-32.
- DoS (Department of Statistics, Malaysia). 2012. *Household Income and Basic Amenities Survey Report 2009*. Putrajaya: DoS.

- Deolailkar, A. B. 2002. *Poverty, Growth, and Inequality in Thailand*. ADB Economic and Research Department Working Paper No 8. Manila: ADB (also available on line: http://adb.org/Documents/ERD/Working_Papers/wp008.pdf).
- Deyo, F. C. ed. 1987. *The Political Economy of the New Asian Industrialisation*. Ithaca (N.Y.), L.: Cornell University Press.
- Evers, H. D. 2003. "Transition towards a Knowledge Society: Malaysia and Indonesia in Comparative Perspective." *Comparative Sociology*, 2 (2), pp. 355-373.
- Ezaki, M. 1998. "Globalization and Economic Development: The Newly Industrializing Area of East Asia." F.G. Adams and S. Ichimura eds. *East Asian Development: Will the East Asian Growth Miracle Survive?* pp. 19-37.
- Fajnzylber, F. 1983. *La industrialización trunca de América Latina*. México: Nueva Imagen.
- _____. 1990a. *Industrialización en América Latina: de la "caja negra" al "casillero vacío."* Comparación de patrones contemporáneos de industrialización. Cuadernos de la CEPAL, N 60. Santiago de Chile: Naciones Unidas.
- _____. 1990b. *Industrialization in Latin America: From the "Black Box" to the "Empty Box."* Santiago de Chile: United Nations.
- _____. 2008. (1-a ed. – 1960). *Mudanças sociais no Brasil. Aspectos do desenvolvimento da sociedade brasileira*. São Paulo: Global Editora.
- Ferraz, F. 1990. "A construção da modernidade." J. P. dos Reis Velloso (coord.) *Modernização Política e Desenvolvimento*, pp. 7-19.
- Fishman, Ch. 2012. "The Insourcing Boom, *The Atlantic Magazine*." electronic version: <http://www.theatlantic.com/magazine/archive/2012/12/the-insourcing-boom/309166/> (accessed on Dec. 18, 2012).
- Frank, A. G. 2005. "East and West." P. Herrmann and A. Tausch eds. *Dar al Islam. The Mediterranean, the World System and the Wider Europe: The "Cultural Enlargement" of the EU and Europe's Identity*, pp. 183-229.

- Fröbel, F. 1982. "The Current Development of the World-Economy: Reproduction of Labor and Accumulation of Capital on a World Scale." *Review (the Journal of Fernand Braudel Center)*, 5 (4), pp. 507-555.
- Fröbel, F. et al. 1980. *The New International Division of Labour: Structural Unemployment in Industrialised Countries and Industrialisation in Developing Countries*. L.: Cambridge University Press. Paris: La Maison des Sciences de l'Homme.
- Gaulard, M. 2011. "Les causes de la désindustrialisation brésilienne." *Revue Tiers Monde*, n 205, pp. 171-190.
- Gill, I. and Kharas, H. 2007. *An East Asian Renaissance: Ideas for Economic Growth*. Washington, D.C.: World Bank.
- Gomez, E. T. 2012. "The politics and policies of corporate development: race, rents and redistribution in Malaysia." H. Hill et al. eds. *Malaysia's Development Challenges*, pp. 63-81.
- Gyllenhammar, P. G. 1977. *People at Work*. Reading (Mass.): Addison-Wesley.
- Herrmann, P. and Tausch, A. eds. 2005. *Dar al Islam. The Mediterranean, the World System and the Wider Europe: The "Cultural Enlargement" of the EU and Europe's Identity*. N.Y.: Nova Science Publishers.
- Hersch, J. 1993. *The USA and the Rise of East Asia since 1945. Dilemmas of the Postwar International Political Economy*. Houndmills, Basingstoke, L.: Macmillan, N.Y.: St. Martin's Press.
- _____. 1998. "The Impact of US Strategy: Making Southeast Asia Safe for Capitalism." J. D. Schmidt et al. eds. *Social Change in Southeast Asia*, pp. 23-39.
- Hew, D. 2006. "Globalisation and the Challenges Facing Malaysia's Economy." Saw Swee-Hock and K. Kesavapany eds. *Malaysia: Recent Trends and Challenges*, pp. 260-274.
- Hill, H. et al. eds. 2012. *Malaysia's Development Challenges: Graduating from the Middle*. L., N.Y.: Routledge.
- IMF (International Monetary Fund). 1979. *International Financial Statistics*

- Yearbook 1979*. Washington, D.C.: IMF.
- Inozemtsev, V. 2001. *One World Divided: Existing Causes and Possible Results of the Coming Post-Economic Revolution*. Leeds: Wisdom House.
- Inozemtsev, V. and Dutkiewicz, P. eds. 2013. *Democracy versus Modernization: A dilemma for Russia and for the world*. L., N.Y.: Routledge
- Jaguaribe, H., Guilherme dos Santos, W., Paiva Abreu, M. de, Fritsch, W., Bastos de Ávila, F. 1986. *Brasil, 2000. Para um novo Pacto Social*. 3-a ed. Rio de Janeiro: Paz e Terra (1-a ed. – 1985).
- Jomo, K.S. ed. 1998. *Tigers in Trouble: Financial Governance, Liberalisation and Crises in East Asia*. L., N.Y.: Zed Books, Hong Kong: Hong Kong University Press.
- Johnson, Ch. 1982. *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*. Stanford (Cal.): Stanford University Press.
- _____. 1987. "Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea, and Taiwan." F. Deyo ed., *The Political Economy of the New Asian Industrialism*, pp. 136-164.
- Jones, G. 2012. "Demographic and labour force dynamics." H. Hill *et al.* eds. *Malaysia's Development Challenges*, pp. 255-275.
- Krasilshchikov, V. 2008. *The Rise and Decline of Catching Up Development: The Experience of Russia and Latin America with Implications for the Asian "Tigers"*, 2-nd ed. (e-Book), Universidad de Málaga, Málaga, Entelequia y Grupo Eumed.net., Cádiz: (<http://www.eumed.net/entelequia/en.lib.php?a=b008>; <http://www.eumed.net/entelequia/pdf/b008.pdf>). (Also published by CAEI (el Centro Argentino de Estudios Internacionales), Buenos Aires, 2010. - <http://www.caei.com.ar/es/irebooks.htm> <http://www.caei.com.ar/ebooks/ebook42.pdf>).
- _____. 2013. "From authoritarianism to democracy along the paths of modernization: From the general to the specific." V. Inozemtsev and P. Dutkiewicz eds. *Democracy versus Modernization: A dilemma for Russia and for the world*, pp. 167-178.

- Lauridsen, L. S. 1998. "Thailand: Causes, Conduct, Consequences." K.S. Jomo ed. *Tigers in Trouble: Financial Governance, Liberalisation and Crises in East Asia*, pp. 137-161.
- Lee, Hock Guan. 2006. "Globalisation and Ethnic Integration in Malaysian Education." Saw Swee-Hock and K. Kesavapany eds. *Malaysia: Recent Trends and Challenges*, pp. 230-259.
- Maddison, A. 2003. *The World Economy: Historical Statistics*. Paris: OECD.
- Markillie, P. 2012. "A third industrial revolution." *The Economist, Special report (supplement)*. (April 21-27)
- Marquetti, A. 2004. "A Economia Brasileira no Capitalismo Neoliberal: Progreso Técnico, Distribuição de Renda e Mudança Institucional." *Artigo apresentado ao VIII Encontro Nacional de Economia Política (Sociedade Brasileira de Economia Política)* (www.sep.org.br/artigos...).
- MASTIC (Malaysian Scientific-Technological Information Centre). 2000. *National Survey of Research and Development 2000*. Kuala Lumpur: MASTIC.
- _____. 2004. *National Survey of Research and Development 2004*. Putrajaya: MASTIC.
- _____. 2007. *National Survey of Research and Development 2006*. Putrajaya: MASTIC.
- _____. 2010. *Malaysian Science and Technology Indicators 2010*. Putrajaya: MASTIC.
- MoF (Ministry of Finance of Malaysia). 2000. *Economic Report 1999/2000*. Kuala Lumpur: Min. of Finance.
- _____. 2004. *Economic Report 2004/2005*. Putrajaya: Min. of Finance.
- _____. 2007. *Economic Report 2007/2008*. Putrajaya: Min. of Finance.
- _____. 2009. *Economic Report 2009/2010*. Putrajaya: Min. of Finance.
- _____. 2011. *Economic Report 2011/2012*. Putrajaya: Min. of Finance.
- _____. 2012. *Economic Report 2012/2013*. Putrajaya: Min. of Finance.
- Nabli, M. K. ed. 2011. *The Great Recession and Developing Countries: Economic Impact and Growth Prospects*. Washington, D.C.: World Bank.

- NEAC (National Economic Advisory Council). 2010. *New Economic Model for Malaysia. Part I: Strategic Policy Directions*. Putrajaya: NEAC.
- Nelson, J. M. 2012. "Political challenges in economic upgrading: Malaysia compared with South Korea and Taiwan." H. Hill *et al.* eds. *Malaysia's Development Challenges*, pp. 43-62.
- Nordhaug, K. 2002. "Globalisation and the State: Theoretical Paradigms." *The European Journal of Development Research*, 14 (1), pp. 5-27.
- NSO (National Statistical Office of Thailand). 1994. *Thailand in Figures 1992-1993*. Bangkok: Alpha Research Company.
- _____. 1997. *Thailand in Figures 1995-1996*. Bangkok: Alpha Research Company.
- _____. 2004. *Thailand in Figures 2003*. Bangkok: Alpha Research Company.
- O'Donnell, G. 1973. *Modernization and Bureaucratic-Authoritarianism: Studies in South American Politics*. Berkeley: University of California Press.
- _____. 1979. "Tensions in the Bureaucratic-Authoritarian State and the Question of Democracy." D. Collier ed. *The New Authoritarianism in Latin America*, pp. 285-318.
- Pack, H. 2001. "Technological Change and Growth in East Asia: Macro versus Micro Perspectives." J. E. Stiglitz and Sh. Yusuf eds. *Rethinking the East Asian Miracle*. pp. 95-142.
- Palma, J. G. 2006. "Stratégies actives et stratégies passives d'exportation en Amérique latine et en Asie orientale: La croissance liée à la composition particulière des produits et à la spécificité des institutions." *Revue Tiers Monde*, n 186, pp. 249-280.
- Pempel, T. J. 1999. "The Development Regime in a Changing World Economy." M. Woo-Cumings ed. *The Developmental State*, pp. 137-181.
- Pochmann, M. 2010. *Desenvolvimento e Perspectivas Novas para o Brasil*. São Paulo: Cortez Editora.
- Ragayah, H. M. Z. 2012. "Poverty Eradication and Income Distribution." H. Hill *et al.* eds. *Malaysia's Development Challenges*, pp. 233-254.

- Reis Velloso, J.P. dos (coord.) 1990. *Modernização Política e Desenvolvimento*. Rio de Janeiro: José Olympio.
- Rostow, W.W. 1986. *The United States and the Regional Organization of Asia and the Pacific, 1965-1985*. Austin: University of Texas Press.
- Salama, P. 2006. *Le défi des inégalités. Amérique latine/Asie: Une comparaison économique*. Paris: La Découverte.
- Sarel, M. 1997. *Growth and Productivity in ASEAN Countries*. Washington, D.C.: IMF (available on line: <http://www.imf.org/external/pubs/ft/wp/wp9797.pdf>).
- Saw Swee-Hock and Kesavapany K. eds. 2006. *Malaysia: Recent Trends and Challenges*. Singapore: ISEAS.
- Serra, J. 1979. "Three Mistaken Theses Regarding the Connection between Industrialization and Authoritarian Regimes." D. Collier ed. *The New Authoritarianism in Latin America*, pp. 99-135.
- Schmidt, J. D. et al. eds. 1998. *Social Change in Southeast Asia*, Harlow (Essex). N.Y.: Addison Wesley Longman.
- Schneider, B. R. 1999. "The *Desarrollista* State in Brazil and Mexico." M. Woo-Cumings ed. *The Developmental State*, pp. 276-305.
- Shenin, S. Y. 2005. *America's Helping Hand: Paving the Way to Globalization (Eisenhower's Foreign Aid Policy and Politics)*. N.Y.: Nova Science Publishers.
- Singer, H. et al. eds. 2006. *Newly Industrializing Countries after Asian Crisis*, part V. Delhi: B.R. Publishing Corporation.
- Singh Tyndall, P. 2002. "Multimedia Super Corridor: Introducing a New Economy in Malaysia." Chia Siow Yue and J. J. Lim eds. *Information Technology in Asia: New Development Paradigms*, pp. 177-194.
- Stepan, A. ed. 1973. *Authoritarian Brazil: Origins, Policies, and Future*. New Haven, L. Yale University Press.
- Stiglitz, J. E. and Yusuf, S. H. eds. 2001. *Rethinking the East Asian Miracle*. N. Y.: Oxford Univ. Press, Washington, D.C.: World Bank.

- UNCTAD (United Nations Conference on Trade and Development). 1993. *Handbook of International Trade and Development Statistics*. N.Y., Geneva: United Nations.
- _____. 1996. *Trade and Development Report 1996*. N.Y., Geneva: United Nations.
- _____. 1997. *World Investment Report 1997 – Transnational Corporations, Market Structure and Competition Policy*. N.Y., Geneva: United Nations.
- _____. 2003. *World Investment Report 2003 – FDI Policies for Development: National and International Perspectives*. N.Y., Geneva: United Nations.
- _____. 2011. *World Investment Report 2011 – Non-Equity Modes of International Production and Development*. N.Y., Geneva: United Nations.
- _____. 2012. *World Investment Report 2012 – Towards a New Generation of Investment Policies*. N.Y., Geneva: United Nations.
- UNDP (United Nations Development Programme). 2007. *Thailand Human Development Report 2007: Sufficiency Economy and Human Development*. Bangkok: United Nations.
- _____. 2009. *Thailand Human Development Report 2009: Human Security, Today and Tomorrow*. Bangkok: United Nations.
- UNESCAP (United Nations Commission for Asia and the Pacific). 2004. *Economic and Social Survey of Asia and the Pacific 2004: Asia-Pacific Economies: Sustaining Growth and Tackling Poverty*. N.Y.: United Nations.
- Wade, R. 1990. *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. Princeton (N.J.): Princeton University Press.
- _____. 1998. “The Asian Crisis and the Global Economy: Causes, Consequences, and Cure.” *Current History*, 97 (622), pp. 361-373.
- Woo-Cumings, M. 1999. “Introduction: Chalmers Johnson and the Politics of Nationalism and Development.” M. Woo-Cumings ed. *The Developmental State*, pp. 1-31.
- Woo-Cumings, M. ed. 1999. *The Developmental State*. Ithaca (N.Y.), L.: Cornell University Press.

- World Bank. 1993. *The East Asian Miracle. Economic Growth and Public Policy*. Oxford University Press, Oxford, Washington, D.C.: World Bank.
- Yusof, Z. A. 2001. "Income Distribution in Malaysia." C. Barlow ed. *Modern Malaysia in the Global Economy: Political and Social Change into the 21-st Century*, pp. 71-93.
- Yusuf, Sh. and Nabeshima, K. 2009. *Tiger Economies Under Threat: A Comparative Analysis of Malaysia's Industrial Prospects and Policy Options*. Washington, D.C.: World Bank.

Call for Papers

Journal of East Asian Economic Integration

With great pleasure,
the *Journal of East Asian
Economic Integration* is now
welcoming submissions

AIMS and SCOPE

The *Journal of East Asian Economic Integration* is an economic journal, for the promotion of interdisciplinary research on international economics. Published as a quarterly by the Korea Institute for International Economic Policy, a Korean government-funded economic think-tank, the journal is global in perspective and covers both theory and empirical research.

The Journal aims to facilitate greater understanding of all issues pertinent to integration of diverse economies of East Asia through publication of rigorous analyses by renowned experts in the field. The JEAI connects policy and theory, providing empirical analyses and practical policy suggestions for the economies in the region.

Topics for articles in the JEAI include, but are not limited to: Trade and Investment, Economic Integration; International Finance; International Monetary Cooperation; Bilateral and Multilateral Economic Cooperation among East Asian Countries; and International Economic Cooperation for Korean Unification.

TOPICS COVERED

The *Journal of East Asian Economic Integration* brings together articles from many different realms of economics at both regional and global levels. Trade, investment, finance, and regional studies, in which relevant to East Asian Economic Integration, are a major focus. Specific areas of interest include, but are not limited to:

- Trade and Investment Issues
- Economic Integration
- APEC · ASEAN · ASEM
- International Finance
- Liberalization of Financial Services and Capital
- International Cooperation for Korean Unification

NOTES FOR CONTRIBUTORS

SUBMISSION GUIDELINE :

Refer to our website <http://www.jeai.org>.

SUBMISSION DEADLINE :

The journal is published every March, June, September and December of each year and submissions are accepted for review on an ongoing basis (no specific deadline).

AWARD FOR JEAI

The *Journal of East Asian Economic Integration* Award is given annually to articles that have made exemplary contributions to advance the public as well as academic understanding of international economics. Every article published in the journal is given an honorarium of KRW 2,500,000; and annual nominations for the outstanding and noteworthy articles include KRW 5,000,000 prize and a detailed nomination statement describing how the selected papers have contributed to the knowledge of international economics.

